

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

DEFENSE BUSINESS OPERATIONS FUND
CONSOLIDATED STATEMENT OF FINANCIAL
POSITION FOR FY 1994

Report No. 95-267

June 30, 1995

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Department of Defense

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Acronyms

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
FMR	Financial Management Regulation
IG	Inspector General
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**



June 30, 1995

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER OF THE
DEPARTMENT OF DEFENSE**

**SUBJECT: Audit Report on the Defense Business Operations Fund Consolidated
Statement of Financial Position for FY 1994 (Report No. 95-267)**

We are providing this report for your information and use and for use by the Congress. Financial statement audits are required by the Chief Financial Officers Act of 1990. Office of Management and Budget Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, requires the Inspector General, Department of Defense, to render an opinion on the financial statements and report on the adequacy of internal controls and compliance with laws and regulations. We considered comments on a draft in preparing this final report. We also plan to issue a separate report detailing the major problem areas that prevent us from rendering an opinion on the DBOF financial statements.

We are unable to render an opinion on the Consolidated Statement of Financial Position because of the lack of a sound internal control structure for the DBOF and significant deficiencies in the accounting systems, which prevented the preparation of accurate financial statements. Our audit was impeded by the failure of DoD to provide a timely consolidated financial statement, in part due to repeated adjustments by Navy management. Part I of this report explains our disclaimer in more detail. Part II discusses material weaknesses in internal controls and noncompliance with laws and regulations involving the accounts on the statement of financial position. This report contains no potential monetary benefits. We are providing relevant appendixes in Part III of this report for management's use.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Raymond D. Kidd, Audit Program Director, at (703) 604-9110 (DSN 664-9110), or Mr. John M. Seeba, Audit Project Manager, at (703) 604-9134 (DSN 664-9134). The distribution of this report is in Appendix H. A list of audit team members is inside the back cover.

**Robert J. Lieberman
Assistant Inspector General
for Auditing**

Office of the Inspector General, DoD

Report No. 95-267
(Project No. 4FH-2010)

June 30, 1995

**Defense Business Operations Fund Consolidated Statement of
Financial Position for FY 1994**

Executive Summary

Introduction. The Chief Financial Officers Act of 1990 requires an annual audit of the financial statements of the Defense Business Operations Fund. The Defense Business Operations Fund was established as a revolving fund in FY 1992 and consists of various business areas. Functional and cost management responsibilities rest with the Military Departments and Defense agencies. A Defense Business Operations Fund Corporate Board was established to develop, review, and coordinate all policies and procedures; establish operational and capital investment goals; and oversee business performance. The Defense Business Operations Fund's financial statements for FY 1994 reported total assets of \$102.6 billion and total liabilities of \$17.4 billion.

Objectives. The objective of the audit was to determine whether the Statement of Financial Position of the Defense Business Operations Fund for FY 1994 was fairly presented in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. In addition, we determined whether controls over the accounts within the Statement of Financial Position were adequate to ensure that financial statements were free of material error. We also assessed compliance with laws and regulations for transactions and events that have a direct and material effect on the financial statements.

Disclaimer of Opinion. We were unable to render an opinion on the Statement of Financial Position of the Defense Business Operations Fund as of September 30, 1994. We were able to evaluate some internal controls and aspects of compliance with laws and regulations. However, we were unable to render an opinion on the Statement of Financial Position because of the lack of a sound internal control structure for the Defense Business Operations Fund and significant deficiencies in the accounting systems, which prevented the preparation of accurate financial statements.

Internal Controls. Overall, management had not established a sound internal control structure. Material internal control weaknesses continue to plague the Defense Business Operations Fund's financial systems and were found in each of the accounts reviewed. We were unable to determine the fairness of account balance presentations by other audit tests and procedures.

- o For Inventory, material internal control weaknesses precluded the determination of a supportable and properly valued account balance.

- o For Accounts Receivable, transactions without supporting documentation were recorded, transactions were incorrectly recorded, and reimbursements were not posted or recorded.

- o For the Property, Plant, and Equipment account, missing assets could not be located, and assets were incorrectly recorded.

- o For Accounts Payable, disbursements were not recorded or posted, supporting subsidiary records were not maintained, and negative liabilities were reported.

- o For Other Intragovernmental Liabilities, invalid transactions were caused by system-wide processing problems.

Part II. A. contains our report on internal controls.

Compliance with Laws and Regulations. Due to delays caused in part by the Navy, DoD did not comply with the Federal Financial Management Act of 1994, which established a deadline of March 31 of the year following the financial statements for FYs 1994 and 1995 to provide unaudited financial statements to the Office of Management and Budget. The statements provided to us were dated April 24, 1995, and still contained a qualification concerning the information provided by the Navy. Additionally, this is the third consecutive year that the consolidated financial statements were not provided to us on a timely basis so that we could perform our audit. In the future, we will not be able to complete audits as required by law unless the Under Secretary of Defense (Comptroller) can reduce lead times for producing financial statements.

We concluded that the systems of accounting and internal controls do not completely or accurately disclose the financial position of the activities of the Defense Business Operations Fund as required by title 31, United States Code. We were unable to determine the range and magnitude of noncompliance with fiscal statutes.

We identified noncompliance with regulations in such areas as accounting systems; standard general ledger; property, plant, and equipment; inventory valuation; accounting estimates; and cash reconciliation. Those instances of noncompliance materially affected the reliability of the Defense Business Operations Fund's financial statements. Part II. B. contains our report on compliance with laws and regulations. Part III, Appendix C, lists the laws and regulations tested.

Related Reports. We will issue a separate report detailing the major reasons why an opinion on the financial statements of the Defense Business Operations Fund cannot be rendered, and explaining the progress made by DoD in correcting the fundamental problems in the internal control structure.

Management Comments. This report contains no recommendations that are subject to resolution in accordance with DoD Directive 7650.3; accordingly, comments are not required. We issued a draft of this report on May 25, 1995, and received comments from the Under Secretary of Defense (Comptroller) and the Navy. The Under Secretary of Defense (Comptroller) generally concurred with the report but made suggestions to clarify some issues. The Navy also provided technical comments that were considered in preparing the final report. See Part II for a discussion of management's comments and Part IV for the complete text of the comments. Specific recommendations on internal controls and compliance with regulations are included in the audit reports listed in Appendix D.

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Part I - Opinion

Opinion

Disclaimer of Opinion

We were unable to render an opinion on the Consolidated Statement of Financial Position of the Defense Business Operations Fund (DBOF, the Fund) as of September 30, 1994. The financial statements submitted to us were dated April 24, 1995. The lack of a sound internal control structure for the DBOF and significant instances of noncompliance with regulations resulted in our inability to render an opinion on the statement. For example, we noted a negative balance of approximately \$7.5 billion in the Inventory In-Transit account, which is a physical impossibility. The exact magnitude of this misstatement is undeterminable. This material anomaly in the financial statements indicates that the internal controls associated with the finance and accounting systems are not reliable, and by itself would be sufficient to preclude an opinion on the Consolidated Statement of Financial Position. Until a sound internal control structure is established and in place for the DBOF, we will remain unable to perform other audit tests and procedures to satisfy ourselves concerning the fair presentation of the financial statements.

Auditing Standards

We conducted our audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States (the Comptroller General), as implemented by the Inspector General (IG), DoD, and Office of Management and Budget (OMB) Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Statements are free of material misstatements. We relied on the guidelines suggested by the President's Council on Integrity and Efficiency and our professional judgment in assessing the materiality of matters impacting the fair presentation of the financial statements and related internal control weaknesses.

Accounting Principles

Accounting principles and standards for the Federal Government remain under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Director, OMB; the Secretary of the Treasury; and the Comptroller General, who are the principals of the Joint Financial Management Improvement Program (JFMIP).

Specific standards agreed on by those three officials are issued by the Director, OMB, and the Comptroller General. To date, three accounting standards and one accounting concept have been published in final form, and three accounting standards and one accounting concept have been released in draft form. See Table 1 for a list of the accounting standards and concepts.

Table 1. OMB Statements of Federal Financial Accounting Standards and Concepts

<u>Number</u>	<u>Title</u>	<u>Status</u>	<u>Date</u>
Standard No. 1	Accounting for Selected Assets and Liabilities	Final	March 30, 1993
Standard No. 2	Accounting for Direct Loans and Loan Guarantees	Final	August 23, 1993
Standard No. 3	Accounting for Inventory and Related Property	Final	October 27, 1993
Concept No. 1	Objectives of Federal Financial Reporting	Final	September 2, 1993
Concept No. 2	Entity and Display	Draft	August 1994
TBD	Managerial Cost Accounting Standards for the Federal Government	Draft	October 7, 1994
TBD	Accounting for Liabilities of the Federal Government	Draft	November 7, 1994
TBD	Accounting for Property, Plant, and Equipment	Draft	February 28, 1995

Until all aspects of financial statement reporting are governed by accounting standards that will constitute "generally accepted accounting principles for the Federal Government," agencies are required to follow the hierarchy of accounting principles described in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. The hierarchy constitutes an "other comprehensive basis of accounting" to be used for preparing Federal agencies' financial statements. A summary of the hierarchy defined and approved by the JFMIP Principals is as follows:

- o standards agreed to and published by the JFMIP Principals,
- o form and content requirements of the OMB,

Opinion

- o accounting standards contained in agency guidance on accounting policies, and
- o accounting principles published by other authoritative sources.

Because only three accounting standards and one accounting concept have been published by the JFMIP Principals, most accounting standards for the DoD's "other comprehensive basis of accounting" are contained in DoD accounting policy guidance. Previously, DoD Manual 7220.9-M, the "DoD Accounting Manual," was the primary DoD accounting guidance. Since FY 1992, the Under Secretary of Defense (Comptroller) (USD[C]) has updated sections of the "DoD Accounting Manual," and has incorporated those sections into new volumes of DoD Regulation 7000.14-R, "Financial Management Regulation" (FMR). The USD(C) plans to replace all sections of the "DoD Accounting Manual" with the FMR. The FMR, once completed, will serve as the single DoD-wide financial management regulation for use by all DoD Components for accounting, budgeting, finance, and financial management education and training.

Performance Measures

Performance measures have not been developed for the DBOF Consolidated Financial Statements, and are not required by "DoD Guidance on Form and Content of Financial Statements for FY 1994 and FY 1995 Financial Activity," October 20, 1994; accordingly, none were included. Performance measures are objective indicators of program effectiveness or efficiency that are directly tied to program results. Performance measures have been created for the DoD Components, the Military Departments, and the Defense agencies. Reviews of performance measures are included in the audit reports for those entities. Until the information provided in the DBOF Consolidated Financial Statements fairly presents the financial position of the DBOF, use of performance measures at that level could cause misleading results.

Overview

We also reviewed the financial information provided in the Overview to the DBOF FY 1994 financial statements. We did not find any instances in which the information presented in the Overview was materially inconsistent with the information presented in the Principal Statements. That information has not been audited by us; accordingly, we are not expressing an opinion on that information.

Audit Assistance

We relied on audit assistance from the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency. See Appendix D for specific areas and the scope of information reviewed by those audit organizations. The information presented in this report is a summary of the most significant deficiencies reported by the Service audit organizations. Refer to Service audit reports and IG, DoD, audit reports, as listed in Appendix D, for detailed explanations of the findings summarized in this report.

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Part II - Audit Results

Audit Background

The Chief Financial Officers Act requires an annual audit of financial statements for revolving funds such as the DBOF. Preparation of the financial statements is the responsibility of the Defense Finance and Accounting Service (DFAS). Information contained in the statements is the joint responsibility of the DoD Components and DFAS. Our responsibility is to express an opinion on those statements based on our audit. Part III, Appendix A, provides the scope and methodology for the audit.

Fund History. The DBOF was created by the Congress on October 1, 1991, by combining DoD- and Service-owned revolving funds previously called the stock and industrial funds. In addition, the DFAS, the Defense Information Systems Agency, the Defense Commissary Agency, the Defense Technical Information Center, the U.S. Transportation Command, the Joint Logistics Systems Center, and a Defense Logistics Agency function (the Defense Reutilization and Marketing Service) were added to the DBOF. Part III, Appendix E, shows the reporting entities that make up the DBOF.

Functional and cost management responsibilities rest with the Military Departments and Defense agencies. The DBOF Corporate Board was established to develop, review, and coordinate policies, procedures, and implementation. The DBOF reported total assets of \$102.6 billion and total liabilities of \$17.4 billion on its consolidated financial statements for FY 1994.

Fund's Purpose. The Fund is intended to provide improved financial management tools and establish incentives to control resources with greater efficiency. Those tools should be used to identify the total cost of business operations related to the production of customer goods and services. The Fund management process was created to:

- o foster a businesslike buyer-seller approach that enables customers to make economical buying decisions and forces sellers to become more cost-conscious;
- o identify the full costs of items, measure performance on the basis of cost and output goals, and foster efficiency and productivity improvements;
- o consolidate cash control and reduce required cash balances; and
- o provide timely and accurate information to decision makers at all levels in order to measure business performance.

DBOF Improvement Plan. During FY 1993, the Secretary of Defense directed a review and evaluation of the DBOF. A steering committee and an expert team, both composed of representatives of the various DoD Components, was assembled "to review, analyze, and report on policies and procedures already promulgated for the DBOF, the information available to business managers within the Fund, and the methodologies used to budget and execute the Fund's financial plan."

The results of the expert team's review, presented to the steering committee and the Deputy Secretary of Defense, indicated four general areas in which improvements were needed and why improvements were needed in each:

- o accountability and control, to improve the overall effectiveness of the Fund and measurement of the results;
- o DBOF structure, to ensure that the structure of the Fund is properly defined and appropriate business areas are included;
- o policy and procedures, to provide adequate guidance for execution of the Fund and the mechanics for day-to-day operations; and
- o financial systems, to improve, standardize, and modernize supporting financial systems to provide better management information.

DBOF Progress Report. The management of the DBOF has made some progress in the four areas. In the "Defense Business Operations Fund Progress Report," February 1, 1995, DoD reported several actions taken to improve the DBOF. Specifically, the DBOF Corporate Board was established. In addition, the following subcommittees were established under the direction of the Corporate Board:

- o a subcommittee to address the significant policies requiring immediate development (November 1993);
- o a subcommittee for performance review to develop the requirements for business area performance reviews and to present information on financial and performance effectiveness to the Corporate Board (November 1993); and
- o a subcommittee for cost reduction to recommend policies and actions to reduce the costs of doing business by DBOF providers (March 1994).

The USD(C) through the Corporate Board, has issued decision papers on military pricing, major real property maintenance and repair, cash management, capital purchasing, mobilization costs and policy, replacement inventory, inventory revaluation, net operating results, and selection of interim migratory systems. Other policies and procedures are under development.

Audit Objectives

Our overall objective was to determine whether the FY 1994 Consolidated Statement of Financial Position of the DBOF Principal Statements is presented fairly in accordance with OMB Bulletin 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Additional objectives were to evaluate internal controls and compliance with applicable laws and regulations.

Internal Controls. Our audit objective was to determine whether controls over transactions supporting the accounts in the Consolidated Statement of Financial Position were adequate to ensure that the accounts were free of material error. In planning and performing our audit of the DBOF accounts for the year ended September 30, 1994, we evaluated the internal control structure, including implementation of the DoD internal management control program. The purposes of this evaluation were to:

- o determine our auditing procedures for expressing an opinion on the financial statements;

- o determine whether an internal control structure had been established;

and

- o determine whether the internal control structure ensured that the statements were free of material misstatements.

That determination included obtaining an understanding of the internal control policies and procedures, as well as assessing the level of control risk relevant to all significant cycles, classes of transactions, and account balances. For those significant control policies and procedures that had been properly designed and placed in operation, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed. For areas where internal controls were determined to be weak, we attempted to perform tests to determine the level of assurance that could be placed on those controls. The lack of an adequate internal control structure resulted in a disclaimer of opinion on the financial statements.

We classified the significant internal controls, policies, and procedures into the following accounts: Accounts Receivable; Advances and Prepayments; Inventory; Property, Plant, and Equipment; Stockpile Materiel; Work in Process; Other Entity Assets; Accounts Payable; and Other Intragovernmental Liabilities.

Compliance With Laws and Regulations. Our audit objective was to assess compliance with laws and regulations for those transactions and events that have a direct and material effect on the financial statements. Material instances of noncompliance are failures to follow requirements, or violations of prohibitions

contained in laws or regulations. Such failures and violations are those that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the Principal Statements, or those whose sensitive nature would cause them to be perceived as significant by others. We were unable to accomplish all tests necessary to determine compliance with laws and regulations. Weak internal controls and lack of audit trails for transactions prevented us from obtaining sufficient information to complete this objective.

The Secretaries of the Military Departments; the USD(C); directors of affiliated Defense agencies; and the Director, Defense Finance and Accounting Service (DFAS), are responsible for ensuring compliance with laws and regulations applicable to the Fund. In our effort to obtain reasonable assurance about whether the Principal Statements were free of material misstatements, we tested compliance with laws and regulations that may directly affect the financial statements and other laws and regulations designated by the OMB and the DoD. See Appendix C for a list of laws and regulations reviewed.

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Part II. A. - Review of Internal Controls

Introduction

We examined the internal control structure of the DBOF for the year ended September 30, 1994. Management of the Fund is responsible for establishing and maintaining an internal control structure. In fulfilling that responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable but not absolute assurance that:

- o transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;

- o funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation;

- o transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the consolidating statements, and in compliance with any other laws and regulations that the OMB, entity management, or the IG, DoD, have identified as being significant for which compliance can be objectively measured and evaluated;

- o data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information; and

- o performance measures exist and are adequate to enable the Fund's management to identify and correct problems.

Reportable Conditions

A sound internal control structure had not been established for DBOF. Our review of internal controls for the Fund disclosed material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. We also identified conditions that we considered to be reportable under OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment,

could adversely affect the organization's ability to effectively control and manage its resources and ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal control structure does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited, or material to a performance measure or aggregation of related performance measures, and not be detected within a timely period by employees in the normal course of performing their functions.

Overall Conditions Noted. Operational management of the DBOF is fragmented among numerous activities within the Military Departments and a variety of Defense agencies. The organizational structure and operational control of these activities has not facilitated establishing and implementing a sound internal control structure for the overall Fund. Rather, management has remained disjointed, with limited progress in the key elements of an internal control structure. Specifically, the control environment, accounting systems, and control procedures need further improvement.

A major factor in the auditors' consideration of the control environment is the effectiveness of management control methods over the exercise of authority delegated to others and supervision of overall entity activities. The DBOF Corporate Board was established in part to address the pressing need for consistent policy and procedures, but is not intended to fulfill Fund management responsibilities. This arrangement, while potentially workable, has significantly complicated and delayed essential action to enhance accounting systems and control procedures. Without a sound internal control structure, the financial information provided to management for the operation of the Fund, as well as for the financial statements, cannot be relied upon in making decisions or assessing performance. As a result, DoD is unable to determine if the fundamental objective of DBOF, to reduce the cost of businesslike services, is being achieved.

Cash Management.* On January 5, 1995, the USD(C) issued a memorandum that delegated cash management responsibilities for the DBOF to the DoD Components composing the Fund. While this decision had no effect on the FY 1994 Statement of Financial Position for the DBOF, we consider the decision to be a significant change in the existing internal control structure that requires our disclosure and will be examined in our FY 1995 and future financial statement audits of the Fund.

*The House Defense Authorization Bill for FY 1996 reverses this decision, but Senate and conference action were still pending as of the date of this report.

Review of Internal Controls

Advance Billing.* In the same memorandum, the USD(C) advised the DoD Components that they should bill in advance as necessary to remain solvent. After the memorandum was issued, we noted that DBOF customers were billed in advance for work not yet performed or completed. The Navy advance billed and collected about \$1.2 billion in order to provide resources to permit continuing operations of the DBOF. We intend to assess internal controls over advance billing as part of our audit of the FY 1995 financial statements of the Fund.

Conditions Noted in Each Account. Material internal control weaknesses existed in each of the accounts reviewed. Internal controls in accounts not reviewed should not be considered adequate until tests can be performed to determine whether those controls are established and working. Due to inadequacies in the internal control structure, we could not determine whether the amounts reflect the total of all errors; therefore, we could not determine an account balance that is fair and reasonable. Specific material weaknesses in each account were as follows.

Inventory In-Transit. In July 1994, DFAS Denver Center personnel acknowledged to the Air Force Audit Agency that material weaknesses existed in the Inventory In-Transit account. In August 1994, the Air Force Audit Agency informed the IG, DoD, of significant problems involving the Inventory In-Transit account within the Air Force Business Operations Fund. The Air Force business activities had a negative balance of approximately \$7.5 billion in the Inventory In-Transit account, which is 11 percent of the total DBOF Inventory, Net, account. The balance fluctuated during the fiscal year and was finally adjusted to negative \$3.8 billion. The existence of a negative balance in an inventory account is a physical impossibility, and such a large misstatement indicates that the accounting systems that produce those figures cannot be relied on. The fact that accounting systems, a significant element of the internal control structure, cannot be relied on is a basis for our disclaimer.

Accounts Receivable. Unsupported and unverified transactions recorded in the Defense Logistics Agency Distribution Depot and the Air Force Depot Maintenance business areas caused Accounts Receivable to be misstated by \$511.8 million (6.2 percent of the Consolidated account). Incorrect recording of Accounts Receivable also caused an overstatement of \$194.8 million (2.4 percent of the Consolidated account). Weak internal controls caused reimbursements to be collected but not posted or recorded; also, funding documents were not received, which prevented the activities from

*The House Defense Authorization Bill for FY 1996 reverses this decision, but Senate and conference action were still pending as of the date of this report.

billing customers. Overstatements in Accounts Receivable may lead management to make decisions based on a false assumption that the activities have more resources than they actually have. Also, errors in recording Accounts Receivable may cause activities to delay billing or be unable to bill customers. No material internal control weaknesses for Accounts Receivable were found at the Army Business Operations Fund activities. See Table 2 for a summary of Accounts Receivable conditions noted.

Table 2. Summary of Accounts Receivable Conditions (\$ millions)

<u>Activity</u>	<u>Condition</u>	<u>Over/ (Under)</u>	<u>Corrected</u>
Air Force Depot Maintenance ¹	Transactions were recorded to Accounts Receivable without supporting documentation.	207.92	No
Air Force Depot Maintenance ¹	An increase was incorrectly recorded to Accounts Receivable on the trial balance.	194.8	No
Defense Logistics Agency Distribution Depot ³	An increase made to balance the general ledger with Treasury records was unsupported and unverifiable.	303.9	No
Defense Logistics Agency Supply Management ⁴	Reimbursements from customers had been collected, but had not been posted to the Accounts Receivable balances.	91.4	No
Defense Logistics Agency Supply Management ⁴	Sufficient internal controls were not established to ensure that collections were recorded in the subsidiary accounts receivable general ledger.	5	No
Defense Logistics Agency Supply Management ⁴	Authorizing funding documents were not received, which prevented the billing of customers.	5	No

¹See Air Force Audit Agency Report No. 94068039.

²Overstatement/understatement could not be determined.

³See IG, DoD, Report No. 95-197.

⁴See IG, DoD, Report No. 95-195.

⁵Amount could not be determined.

Property, Plant, and Equipment. The Property, Plant, and Equipment account was materially understated for the Defense Logistics Agency. As a

Review of Internal Controls

result of IG, DoD, Report No. 94-149, "Property, Plant, and Equipment Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993," June 28, 1994, the account was increased by \$213.4 million (1.9 percent of the Consolidated account) to more accurately account for Property, Plant, and Equipment. However, full implementation of the plan is not scheduled for completion until the end of FY 1995.

The Property, Plant, and Equipment account was overstated by a net of \$63.2 million (0.6 percent of the Consolidated account) on the Navy DBOF Financial Statements. The account was overstated because assets could not be located, costs were unsupported, and assets were incorrectly recorded. The Naval Audit Service recommended adjustments to the Navy DBOF Statement of Financial Position for September 30, 1994, to correct the overstatement.

Accounts Payable. The IG, DoD, the Naval Audit Service, and the Air Force Audit Agency found reportable conditions in Accounts Payable that affected the reliability of the Accounts Payable balances. Those conditions included accounting errors, negative balances, disbursements not posted to the individual Accounts Payable balances, Accounts Payable disbursements that were not recorded, and failure to maintain supporting documentation. Errors in recording Accounts Payable may result in multiple payments for the same services. See Table 3 for a summary of Accounts Payable conditions noted.

Table 3. Summary of Accounts Payable Conditions (\$ millions)

<u>Activity</u>	<u>Condition</u>	<u>Over/ (Under)</u>	<u>Corrected</u>
Army Business Operations Fund Activities ¹	Transactions involving material that had already been paid for or had not been received were reported to DFAS.	2	No
Navy Business Operations Fund Activities ³	Receipt errors were not corrected, high-value account balances were not reviewed, and contract modifications were not maintained.	99.0	Yes
Navy Business Operations Fund Activities ³	Supporting documentation was not maintained.	121.8	
Navy Business Operations Fund Activities ³	The account contained accounting errors, untimely processing and posting, incomplete records, lack of reconciliations, or transactions not meeting criteria.	154.3	No
Navy Business Operations Fund Activities ³	Transactions more than 6 months old were unbilled.	101.84	No
Navy Business Operations Fund Activities ³	Negative liabilities existed.	(38.4)	No
Navy Business Operations Fund Activities ³	The account contained accounting errors and untimely processing and posting of transactions.	43.5	No
Navy Business Operations Fund Activities ³	Negative balances existed for undistributed collections and disbursements.	(682.8)	No
Air Force Supply Management ⁵	Supporting documentation was not maintained for disbursement transactions.	96.9	No

¹See Army Audit Agency Report No. NR95-430.

²Amount could not be determined.

³See Naval Audit Service Report No. 044-95.

⁴Amount represents overage Accounts Payable.

⁵See Air Force Audit Agency Report No. 94068041.

Table 3. Summary of Accounts Payable Conditions (\$ millions)
(cont'd.)

<u>Activity</u>	<u>Condition</u>	<u>Over/ (Under)</u>	<u>Corrected</u>
Air Force Supply Management ⁵	Accounting system did not record accounts payable disbursement transactions.	2,400 ⁶	No
Defense Logistics Agency Distribution Depot ⁷	Unsupported increases were made to balance the general ledger with Treasury records.	97.4	No
Defense Logistics Agency Supply Management ⁸	Disbursements to vendors were not posted to specific Accounts Payable balances.	110.4	No
Defense Logistics Agency Supply Management ⁸	Disbursement transactions were lost during the matching process and not posted to specific Accounts Payable balances.	2	No
Defense Reutilization and Marketing Service ⁹	Accounts Payable transactions were not recorded.	(80.8)	No

²Amount could not be determined.

⁵See Air Force Audit Agency Report No. 94068041.

⁶Overstatement/understatement could not be determined.

⁷See IG, DoD, Report No. 95-197.

⁸See IG, DoD, Report No. 95-195.

⁹See IG, DoD, Report No. 95-220.

Other Intragovernmental Liabilities. The Army's Other Intragovernmental Liabilities account contained invalid transactions of \$351 million (5.4 percent of the Consolidated account). At one inventory control point, an overstatement occurred because the activity did not recoup credits given to retail customers when the customers failed to return assets. In addition, the inventory control point gave erroneous credits for returned items with credit value that exceeded unit prices. However, the activities made adjustments to the financial statements before submitting year-end account balances to the DFAS Indianapolis Center.

The Navy's Other Liabilities account was overstated by \$356.2 million (5.5 percent of the Consolidated account). The account balance was misstated because of system-wide processing problems. Because of the misstatement, there is no assurance that the Other Liabilities account is accurate and reliable. Also, \$356.2 million represents funds that could be put to better use. The Naval Audit Service recommended that, to correct the overstatement, the

Director, DFAS, should adjust the Other Liabilities account by \$356.2 million on the September 30, 1994, Navy DBOF Financial Statements.

Intrafund Eliminations. The Navy did not include the required Intrafund Eliminations note to the financial statements. The Navy should have included at least \$3.2 billion relating to collections and disbursements in the Intrafund Eliminations note. In addition, the lack of intrafund eliminations also caused the revenues to be overstated by \$1.4 billion. The overstatement of revenue is not included in the scope of the audit, but is disclosed due to the magnitude of the misstatement. These problems occurred because the Navy did not have procedures needed to collect data for the note to the financial statements. The Naval Audit Service recommended that DFAS aggressively pursue and develop intrafund elimination reporting procedures for presentation of the FY 1995 financial statements.

Presentation of Financial Statements. In reviewing the individual DBOF activities' financial statements, we found inconsistencies in the amounts in which the figures were expressed. The final versions of the financial statements for four DBOF activities state that the figures are expressed in thousands of dollars, when they are actually expressed in dollars. The financial statements in error are those of the Defense Logistics Agency, the Defense Technical Information Center, the Defense Information Systems Agency, and the Defense Finance and Accounting Service.

Management Comments and Audit Response

Under Secretary of Defense (Comptroller) Comments. The USD(C) generally concurred with our report. Areas of disagreement originate from the other audit reports that are summarized in this report, and will be subject to audit resolution and mediation as needed.

Navy Comments. The Navy objected to our reference that the audit was impeded in part due to repeated adjustments to the Navy DBOF financial statements by Navy management. The Navy stated that their responsibility for the financial statements required the correction of material errors and omissions that clearly would distort the financial statements. The Navy also stated that "our" management representation letter documented material errors and omissions. The Navy also provided technical comments that were considered in preparing the final report.

Audit Response. The Navy comments failed to consider the requirement of the Federal Financial Management Act of 1994 to submit the FY 1994 DBOF financial statements to OMB by March 31, 1995. The "DoD Guidance on Form and Content of Financial Statements for FY 1994/1995

Review of Internal Controls

Financial Activity" required the submission of the FY 1994 financial statements to the IG, DoD, on December 24, 1994, and finalized adjustments by January 31, 1995. The IG, DoD, received the consolidated financial statements on April 24, 1995. The delays caused by late adjustments to the Navy financial statements prevented the DFAS from transmitting the statements to OMB and the IG, DoD, in a timely manner as required by law and regulation. Navy management should make every reasonable attempt to correct errors and omissions in the financial statements. However, taking over 6 months to correct a financial statement is neither reasonable nor useful for purposes of managing a multibillion dollar operation, and reaffirms the serious accounting system problems, as disclosed in the USD(C) management representation letter at Appendix F. Even if the information could be rendered more accurate from such an exercise, the underlying internal control structure deficiencies preclude an audit opinion on fair presentation in the financial statements. For example, such adjustments are not reflected at the transaction level, therefore an audit trail does not exist for us to verify the adjustments. The objective of recent legislation such as the Federal Financial Management Act of 1994 is to encourage DoD to establish a sound internal control structure consisting of an adequate control environment, reliable accounting systems and sufficient control procedures. Production of an accurate financial statement that can be validated by audit is a test of the internal control structure. Navy efforts to fine tune financial statements long after they are due and without regard to the deeply flawed underlying internal control structure were fruitless. It would be far more useful to focus on correcting internal control weaknesses and other fundamental DBOF management problems.

In addition, contrary to the implication in the Navy comments, the Navy did not disclose any serious internal control or compliance problems in its management representation letter for FY 1994. The lack of disclosure in the Navy letter stands in significant contrast to the USD(C) management representation letter, which identifies many serious problems with the internal control structure and compliance that prevent the auditors from rendering a favorable opinion.

Part II. B. - Review of Compliance With Laws and Regulations

Introduction

We evaluated the DBOF for material instances of noncompliance with laws and regulations for the year ended September 30, 1994. The statements submitted to us were dated April 24, 1995. The Chief Financial Officers Act of 1990 requires that audited financial statements be provided to OMB by June 30 of each year. The Federal Financial Management Act of 1994 established a deadline of March 31 of the year following the financial statements for FYs 1994 and 1995 to provide unaudited financial statements to OMB. Starting with the FY 1996 financial statements, DoD must provide audited DoD-wide financial statements to OMB by March 1 of the following year.

Since FY 1992, the USD(C) has updated sections of the "DoD Accounting Manual" and has incorporated those sections into new volumes of the FMR. The USD(C) plans to replace many sections of the "DoD Accounting Manual" by issuing chapters of the FMR. The FMR, once completed, will serve as the single DoD-wide financial management regulation for use by all DoD Components for accounting, budgeting, finance, and financial management education and training.

Reportable Conditions

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions in laws and regulations. Such failures or violations are those that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the Principal Statements, or those whose sensitive nature would cause them to be perceived as significant by others.

Noncompliance With Laws. Due to delays caused in part by the Navy, DoD did not comply with the Federal Financial Management Act of 1994, which established a deadline of March 31, 1995 to provide FY 1994 unaudited financial statements to OMB. The financial statements were dated April 25, 1995. In the future, we will not be able to complete audits as required by public law unless the USD(C) reduces lead times for producing those statements. To improve compliance with the law, pro forma financial statements provided on a quarterly basis would be useful.

Fiscal Statutes. We concluded that the systems of accounting and internal controls do not completely or accurately disclose the financial position of the activities of the DBOF as required by title 31, United States Code. Because of inadequacies in the DBOF internal control structure and the DBOF accounting systems, accurate and reliable accounting and reporting of agency transactions are not ensured. We were unable to determine through audit tests and procedures the range and magnitude of noncompliance with fiscal statutes. Lack of supporting documentation and inadequate or nonexistent audit trails

Review of Compliance With Laws and Regulations

continue to hamper effective oversight. Millions of dollars of unreconciled contracts and accounts, unmatched and mismatched disbursements, negative unliquidated obligations (disbursements in excess of recorded obligations), and overpayments that were undetected until returned by contractors describe an environment in which material noncompliance with laws and regulations can occur and go undetected. We are working closely with the USD(C) to establish integrated accounting systems and improve internal controls to reasonably ensure compliance with fiscal statutes and regulations.

Noncompliance With Regulations. Our examination disclosed widespread noncompliance with regulations that materially affected the reliability of the DBOF financial statements. We were unable to determine through audit tests and procedures the range and magnitude of noncompliance with the regulations identified in Part III, Appendix C, of this report.

Accounting Systems. OMB Circular No. A-127, "Financial Management Systems," requires that accounting systems interface with logistical systems and meet other requirements such as system documentation, audit trails, and general ledger controls. The FY 1994 DFAS Annual Statement of Assurance reported that the majority of the 261 financial management systems do not meet the requirements of OMB Circular No. A-127. Many of the systems perform similar functions, which results in inefficiencies and disparate business practices.

Standard General Ledger. The "DoD Accounting Manual" requires activities to use the standard general ledger chart of accounts. The USD(C) acknowledges that the standard general ledger has not been implemented in the DBOF business areas. One of the systems used by Army supply management, the Commodity Command Standard System, was not using standard general ledger accounts. As a result of a financial statement audit, the U.S. Army Materiel Command submitted a system change request that would implement the standard general ledger. The change should be implemented on October 1, 1995. Two systems used by retail activities, the Standard Army Intermediate Level Supply System and the Standard Army Financial Inventory Accounting and Reporting System, also did not use the standard general ledger. The systems have a conversion program that crosswalks obsolete general ledger accounts to the standard general accounts. These systems are scheduled to be replaced and will not be revised.

Property, Plant, and Equipment. The FMR requires activities to depreciate each building separately. However, existing accounting systems generally prevented determination of depreciation expense. For example, most Army depot maintenance activities do not have an accounting system that allows them to compute depreciation on separate buildings. The Army Materiel Command is addressing this issue.

Inventory Valuation. The Army incorrectly valued inventory, resulting in misstatements of the Inventory account. In accordance with Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," July 30, 1993, DoD policy requires that inventory be revalued to its latest acquisition cost at year's end. This policy also requires

Review of Compliance With Laws and Regulations

that excess, obsolete, and unserviceable material be valued at its net realizable value. Volume 11B of the FMR, December 1994, further clarifies how inventory should now be classified and valued. The Army Audit Agency found that the DFAS procedures were not comprehensive (see Table 4) and recommended that DFAS clarify guidance on how to revalue Army supply management inventory. Army maintenance activities valued all inventory at standard price, regardless of condition, which resulted in overvalued excess and unserviceable inventory. The Army Audit Agency previously recommended that the Army Materiel Command develop procedures for valuing excess and unserviceable inventory held by Depot Maintenance activities.

The Navy DBOF activities did not report excess inventories correctly because disposal of excess items could negatively affect operating results. In addition, local policies did not allow material to be excessed unless credit was received from the supply system. As a result, Material/Supplies, Net, was overstated by \$84.8 million. The Naval Audit Service recommended that the Assistant Secretary of the Navy (Financial Management and Comptroller) identify Operating Materials/Supplies that are excess to requirements and take appropriate action. The Assistant Secretary should also revalue excess Operating Materials/Supplies for financial statement reporting. See Table 4 for a summary of inventory valuation conditions noted.

Table 4. Summary of Inventory Valuation Conditions (\$ millions)

<u>Activity</u>	<u>Condition</u>	<u>Over/ (Under)</u>	<u>Corrected</u>
Army Supply Management ¹	Procedures for determining inventory values were not comprehensive (Inventory, Net).	411	No
Army Supply Management ¹	Stockpile Materiel was valued the same as other on hand inventory.	(483)	No
Army Maintenance Activities ¹	Inventory was valued at standard price, regardless of condition, resulting in overvalued excess and unserviceable inventory.	2	No
Navy Business Operations Fund Activities ³	Excess inventories were not reported correctly.	84.8	No

¹See Army Audit Agency Report No. NR95-430.

²Amount could not be determined.

³See Naval Audit Service Report No. 044-95.

Cash Reconciliation. Before FY 1995, the USD(C) was responsible for managing the Fund's cash. As of February 1, 1995, the USD(C) transferred responsibility for management of the Fund's cash to the DoD Components, the Military Departments, and the Defense agencies. The amounts reported as collected and disbursed on the Navy DBOF financial statements did not agree with individual activities' records, even after cash reconciliations were

performed. The financial statements show that \$22.2 billion was collected and \$24.4 billion was disbursed. These amounts represent the value of collections and disbursements that were successfully processed through the Navy's finance network. Preparers of the Navy's financial statements relied only on information processed through the Navy finance network, while activities used additional information and omitted some information that came from the finance network. Failure to match financial statements and activity records could result in cash management problems and potential Antideficiency Act violations.

Accounting Estimates. The "DoD Accounting Manual" requires that financial transactions be adequately supported with source records and pertinent documents, and prohibits estimates in the Statement of Accountability. The Navy used estimates for collection figures when ships and activities did not report figures in sufficient time to be incorporated in the statements. The Navy developed the estimating process to overcome timing and processing problems. This resulted in the overstatement of collections by \$803 million (1.1 percent of the Consolidated account) in FY 1994. Accounts Receivable was understated by the same amount. Additionally, disbursements were overstated by \$132 million (0.2 percent of the Consolidated account) in FY 1994, and Accounts Payable was understated by \$144 million. Invested Capital was also understated by \$362 million (0.4 percent of the Consolidated account) in FY 1994. The Naval Audit Service recommended adjustments to correct the errors in the financial statements. The Naval Audit Service also recommended that the Director, DFAS, stop estimating collections and disbursements for nonreporting activities.

On October 27, 1994, DFAS directed its subordinate activities to cease estimating and report actual balances only. As of February 28, 1995, two Defense Accounting Offices were still making monthly estimates. The net value of the improper increases in the Fund Balance With Treasury account totaled over \$800 million and represents an overstatement within that account on the Navy DBOF Statement of Financial Position. However, the Naval Audit Service concluded that eliminating those transactions would not result in a violation of the Antideficiency Act. The Naval Audit Service recommended that DFAS eliminate the estimated net collections from data reported to the Fund Balance With Treasury account. The Naval Audit Service also recommended that the Assistant Secretary of the Navy (Financial Management and Comptroller) direct appropriate business areas to bill additional amounts in advance to ensure that Antideficiency Act violations are avoided and cash level criteria are met.

Management Comments and Audit Response

Under Secretary of Defense (Comptroller) Comments. The USD(C) generally concurred with our report. Areas of disagreement originate from the other audit reports that are summarized in this report. The issues in those reports will be addressed through the DoD audit resolution process.

Part III - Additional Information

Appendix A. Scope and Methodology

Statements Reviewed. We examined the Consolidated Statement of Financial Position contained in the Annual Financial Statements of the DBOF for the year ended September 30, 1994. The DBOF Consolidated Financial Statements submitted to us were dated April 24, 1995.

Our audit did not examine all business entities of the DBOF. The excluded entities represent \$8 billion (7.8 percent) of the \$102.6 billion of total DBOF assets. Generally accepted auditing standards require us to consider materiality and audit risk as part of our overall audit work. We do not believe that examining the excluded entities would have affected our disclaimer of opinion. See Part III, Appendix D, "Summary of Work Performed," for a list of entities examined.

To fulfill our responsibility to express an opinion on the Consolidated Statement of Financial Position, we coordinated our audit efforts with the Service audit organizations (the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency). Our combined audit efforts provide a reasonable basis for our results.

Scope of the Review of Internal Controls. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements, including the accompanying notes. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements. For the FY 1994 financial statements, we limited our scope to the Statement of Financial Position. The work performed will form the foundation for work to be done in future years, when additional accounts and statements will be audited.

Our previous audits disclosed an inadequate internal control structure within the DBOF that precluded us from placing any reliance on internal controls or rendering an opinion on the financial statements. This inadequate structure was the basis for our disclaimer of opinion. Additionally, significant deficiencies in inventory, including a negative balance of approximately \$7.5 billion in Inventory In-Transit, were brought to our attention early in the audit. Those deficiencies were material enough to warrant a disclaimer of opinion. As a result, we revised our planned audit work to focus on reviewing internal controls in more detail.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions, and would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

Scope of the Review of Compliance With Laws and Regulations. Compliance with laws and regulations is the responsibility of the Fund's managers. As part of our examination to obtain reasonable assurance that the Fund's Statement of Financial Position was free of material misstatements, we

Appendix A. Scope and Methodology

performed tests of compliance with laws and regulations that may directly affect the financial statements and other laws and regulations designated by the OMB and DoD. See Part III, Appendix C, for a list of laws and regulations reviewed.

As part of our examination, we reviewed management's compliance with DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. We compared management's most recent Annual Statement of Assurance with our evaluation of the Fund's policies, procedures, and systems for documenting and supporting financial, statistical, and other information presented to us in the Overview to the Fund's Principal Statements, as well as supplemental financial and management information. It was not our objective, however, to provide an opinion on overall compliance with such provisions.

Time Period and Locations. The audit was conducted from June 1994 to May 1995 at various offices of the Defense Finance and Accounting Service, the Defense Logistics Agency, and the Military Departments' business areas that are part of the DBOF. A complete list of organizations visited or contacted is in Part III, Appendix G.

Computer-Processed Data. Based on the audit work performed by the Service audit organizations and the IG, DoD, we concluded that computer-processed data were not totally reliable. For evaluations of the DBOF entities' computer-processed data, refer to the reports of the Service audit organizations and the IG, DoD, listed in Appendix D.

Representation Letter. We received a management representation letter from the USD(C) on May 5, 1995, on the DBOF Consolidated Financial Statements. The letter, which is commendably candid, cites major deficiencies in the accounting systems and the standard general ledger, as well as internal control weaknesses and compliance issues for each of the accounts within DBOF. The fact that the accounting systems cannot be relied on to produce reliable data lends support to our decision to disclaim an opinion. See Appendix F for the management representation letter we received from the USD(C). We also received a legal representation letter dated May 18, 1995.

Appendix B. Prior Audits and Other Reviews

Consolidated DBOF Report Summaries

IG, DoD, Report No. 94-161, "Consolidated Statement of Financial Position of the Defense Business Operations Fund for FY 1993," June 30, 1994. The IG, DoD, was unable to express an opinion on the DBOF FY 1993 Consolidated Statement of Financial Position because significant internal control deficiencies existed and significant instances of noncompliance with regulations were found. The IG, DoD, reported numerous internal control problems associated with four accounts of the DBOF financial statements. The principal problems in the Fund Balance With Treasury account were the definition of the account and the reconciliation of balances. The DoD definition of this account was not consistent with accounting principles, which made the balance misleading. Additionally, the individual activities could not reconcile their own portions of the account because the information was integrated with other DoD Fund Balance With Treasury information. Misstatements were reported for the Defense Logistics Agency and the Navy for this account. The Inventory Held for Sale, Net, account and the Inventory Not Held for Sale account also had a number of problems. In addition to valuation and classification problems, many activities had material discrepancies in these accounts. Specifically, for the Inventory Not Held for Sale account, negative inventory balances were reported, and the accuracy of War Reserve assets could not be verified. The Army and the Air Force did not maintain appropriate source documentation for items included in the Property, Plant, and Equipment account, which made those portions of the account unauditable. Also, the Air Force did not report all Property, Plant, and Equipment in the DBOF financial statements. Additionally, the Property, Plant, and Equipment account for the Joint Logistics Systems Center was misstated because that activity had not implemented an effective internal control program.

The IG, DoD, reported numerous instances of noncompliance with regulations. First, the DFAS Indianapolis Center did not use an integrated general ledger to produce the FY 1993 financial statements as required by OMB guidance, and several Army DBOF supply systems did not use the standard general ledger system as required by the "DoD Accounting Manual." The IG, DoD, also reported that the Defense Logistics Agency had not effectively implemented an internal management control program for reporting the results of physical inventories. Also, the Army valued all inventory at standard price, but the Defense Logistics Agency valued reutilization and marketing inventories at standard price. Neither of those valuation policies adheres to the Statement of Federal Financial Accounting Standards Number 1, "Accounting for Selected Assets and Liabilities," March 30, 1993. The IG, DoD, also reported that most Army Depot Maintenance activities did not have accounting systems that allowed them to compute depreciation for separate buildings, as required by the "DoD Accounting Manual." Finally, the Notes to the FY 1993 DBOF Financial Statements were not in accordance with the "DoD Guidance on Form

Appendix B. Prior Audits and Other Reviews

and Content on Financial Statements for FY 1993 and FY 1994 Financial Activity." The financial statements included only 4 notes, not the required 26 notes. No recommendations were made in this report; therefore, management comments were not required, and none were received.

IG, DoD, Report No. 93-134, "Principal and Combining Financial Statements of the Defense Business Operations Fund - FY 1992," June 30, 1993. The IG, DoD, was unable to express an opinion on the DBOF FY 1992 Financial Statements because audit trails were inadequate, accounting systems were inadequate, significant internal control deficiencies existed, significant instances of noncompliance with regulations were found, and legal and management representation letters were not received. The IG, DoD, reported numerous material internal control weaknesses that affected the reliability of the DBOF FY 1992 Financial Statements. Transactions were not properly recorded and accounted for because controls over cash were inadequate; transactions by and for others were not recorded in a timely manner; intrafund transactions were not eliminated or reported; and certain accounts were not properly accounted for. The IG, DoD, could not ensure that assets were safeguarded from unauthorized use because supporting documentation was lacking, and because the Capital Asset and Inventory accounts were not correctly valued and we could not determine whether they existed. The execution of transactions was not in compliance with existing guidance. Reconciliations, uniform accounting systems, and a standard general ledger were lacking, and the weekly flash cash reports were unreliable.

Several instances of noncompliance with laws and regulations materially affected the reliability of the DBOF FY 1992 Financial Statements. For FY 1992, the accounting systems for DBOF did not meet the requirements of the Budget and Accounting Procedures Act of 1950 and GAO Title 2, "Policy and Procedures Manual for Guidance of Federal Agencies." The USD(C) was not in full compliance with OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements," which implemented the Chief Financial Officers Act. In addition, quarterly and annual reports to the Treasury on Accounts and Loans Receivable Due From the Public were not accurately prepared. Air Force Supply Management did not follow requirements of the "DoD Accounting Manual." Real properties were improperly reflected as assets on the DBOF financial statements and did not comply with the requirements for Real Property Ownership under title 10, United States Code, Section 2682. Finally, the DFAS Columbus Center and the Defense Commissary Agency did not meet certain provisions of the Prompt Payment Act. No recommendations were made in this report; therefore, management comments were not required. However, we received comments from the Acting Chief Financial Officer. Management generally agreed with the report, but took exception to our reportable conditions on inadequate audit trails and reported instances of noncompliance with Title 2, the "Budget and Accounting Procedures Act of 1950"; OMB Bulletin No. 93-02; and the National Defense Authorization Act. We did not agree with management's comments.

Appendix B. Prior Audits and Other Reviews

Other Related Prior Audit Reports

<u>Report No.</u>	<u>Title</u>	<u>Date</u>
General Accounting Office		
AIMD-95-79	Defense Business Operations Fund (DBOF) ¹ : Management Issues Challenge Fund Implementation (OSD Case No. 9859)	March 1, 1995
AIMD-94-80	Financial Management, Status of the DBOF (OSD Case No. 9339-D)	March 9, 1994
Inspector General, Department of Defense		
95-072	Defense Finance and Accounting Service Work on the FY 1993 Air Force DBOF Financial Statements	January 11, 1995
95-067	Defense Finance and Accounting Service Work on the Air Force FY 1993 Financial Statements	December 30, 1994
95-066	Application Controls - Navy Inventories	December 30, 1994
95-034	Development of Property, Plant, and Equipment Systems	November 21, 1994
95-023	Application Controls Over Selected Portions of the Standard Army Intermediate Level Supply System	November 4, 1994
94-199	Research on Accounting and Financial Reporting at the Defense Information Services Organization	September 30, 1994
94-183	Controls Over Commissary Revenues	September 6, 1994

¹Acronym used in report titles for brevity.

Appendix B. Prior Audits and Other Reviews

<u>Report No.</u>	<u>Title</u>	<u>Date</u>
94-168	Defense Finance and Accounting Service Work on the Army FY 1993 Financial Statements	July 6, 1994
94-167	Selected Financial Accounts on the Defense Logistics Agency DBOF Financial Statements for FY 1993	June 30, 1994
94-163	Management Data Used to Manage the U.S. Transportation Command and Military Department Transportation Organizations	June 30, 1994
94-161	Consolidated Statement of Financial Position of the DBOF for FY 1993	June 30, 1994
94-159	Fund Balances With Treasury Accounts on the FY 1993 Financial Statements of the Defense Logistics Agency Business Areas of the DBOF	June 30, 1994
94-150	Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the DBOF for FY 1993	June 28, 1994
94-149	Property, Plant, and Equipment Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the DBOF for FY 1993	June 28, 1994
94-147	Joint Logistics System Center's Financial Statements for FY 1993	June 24, 1994
94-128	Management Data Used to Manage the Defense Logistics Agency Supply Management Division of the DBOF	June 14, 1994
94-082	Financial Management of the DBOF - FY 1992	April 11, 1994

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<u>Report No.</u>	<u>Title</u>	<u>Date</u>
93-164	Financial Statements of DLA Supply Management Division of the DBOF (Defense Fuel Supply Center Financial Data) for FY 1992	September 2, 1993
93-153	DBOF Communication Information Services Activity Financial Statements for FY 1992	August 6, 1993
93-151	Compliance With the Federal Managers' Financial Integrity Act at the Defense Commercial Communications Office	July 26, 1993
93-147	Defense Commissary Resale Stock Fund Financial Statements for FY 1992	June 30, 1993
93-134	Principal and Combining Financial Statements of the DBOF for FY 1992	June 30, 1993

Army Audit Agency

NR 94-471	Army DBOF FY 93 Financial Statements: Report of Management Issues	September 29, 1994
NR 94-470	Army DBOF FY 93 Financial Statements: Audit Opinion	June 30, 1994
NR 94-457	DBOF, FY 92 Financial Statements: Common Management Issues	March 30, 1994
NR 94-456	DBOF, Transportation, Army FY 92 Financial Statements: Report of Management Issues	March 30, 1994
NR 94-454	DBOF, Depot Maintenance, Army FY 92 Financial Statements: Report of Management Issues	March 30, 1994
NR 93-463	DBOF Depot Maintenance, Army	June 30, 1993
NR 93-462	DBOF Transportation, Army	June 30, 1993

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<u>Report No.</u>	<u>Title</u>	<u>Date</u>
Naval Audit Service		
053-H-94	Fiscal Year 1993 Consolidating Financial Statements of the Department of the Navy DBOF	June 29, 1994
053-H-93	Fiscal Year 1992, Consolidating Financial Statements of the Department of the Navy DBOF	June 30, 1993
Air Force Audit Agency		
94068020	Opinion on Air Force DBOF, Fiscal Year 1993 Fund Balances with Treasury	June 30, 1994
94068019	Opinion on Air Force DBOF, Fiscal Year 1993 Property, Plant, and Equipment Balances	June 30, 1994
94068018	Opinion on Air Force DBOF, Fiscal Year 1993 Inventories Not Held for Sale Balance	June 30, 1994
94068017	Opinion on Air Force DBOF, Fiscal Year 1993 Inventories Held for Sale Balance	June 30, 1994
94068025	Air Force Depot Maintenance Service, Fiscal Year 1993 Material In-Transit Balances	April 1, 1994
93068005	Internal Controls and Management Issues Related to Laundry and Dry Cleaning Service, DBOF, Fiscal Year 1992 Financial Statements	September 7, 1993

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<u>Report No.</u>	<u>Title</u>	<u>Date</u>
92066008	Review of the Design and Development Activities for the Depot Maintenance Management Information System	August 18, 1993
93068024	Opinion on Air Force Consolidating Statements, DBOF, Fiscal Year 1992 Financial Statements	June 30, 1993
93068012	Opinion on Air Force Distribution Depot, DBOF, Fiscal Year 1992 Financial Statements	June 30, 1993
93068011	Opinion on Air Force Supply Management, DBOF, Fiscal Year 1992 Financial Statements	June 30, 1993
92068003	Opinion on Laundry and Dry Cleaning Service, DBOF, Fiscal Year 1992 Financial Statements	June 30, 1993
92068002	Opinion on Air Force Depot Maintenance, DBOF, Fiscal Year 1992 Financial Statements	June 30, 1993
92071002	Opinion on Air Force Transportation, DBOF, Fiscal Year 1992 Financial Statements	June 29, 1993
92066010	Review of General and Application Controls Within the Contract Depot Maintenance Production and Cost System	April 1, 1993
92066002	Review of General and Application Controls Within the Equipment Inventory, Multiple Status and Utilization Reporting Subsystem	April 1, 1993
92062001	Review of DMIF ² Revenue Accounts, Fiscal Year 1992 Financial Statements	February 28, 1993

²Depot Maintenance Industrial Fund.

Appendix C. Laws and Regulations Reviewed

Subtitle II, The Budget Process, of title 31, United States Code, including the Antideficiency Act provisions found in 31 U.S.C. 1341, "Limitations on Expending and Obligating Amounts;" and 31 U.S.C. 1517, "Prohibited Obligations and Expenditures"

Subtitle III, Financial Management, of title 31, United States Code, including the requirements for accounting and accounting systems and information in 31 U.S.C. 3511, 3512, 3513, and 3514; and the financial statement requirements in 31 U.S.C. 3515

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 100-496, "Prompt Payment Act of 1988," October 17, 1988

Public Law 97-365, "Debt Collection Act," October 25, 1982

Historical and Statutory Notes to 10 U.S.C. 2208, Working-Capital Funds

DoD Regulation 7000.14-R, Volume 1, "General Financial Management Information, Systems, and Requirements," May 1993

DoD Regulation 7000.14-R, Volume 5, "Disbursing Policy and Procedures," December 1993

DoD Regulation 7000.14-R, Volume 8, "Civilian Pay Policies and Procedures," March 18, 1993

DoD Regulation 7000.14-R, Volume 11B, "Reimbursable Operations Policy and Procedures--Defense Business Operations Fund," December 1994

DoD Regulation 7000.14-R, Volume 15, "Security Assistance Policy and Procedures"

DoD Manual 7220.9-M, "DoD Accounting Manual," as amended June 17, 1991

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987

DoD Directive 7200.1, "Administrative Control of Appropriations," as revised July 27, 1987

Joint Financial Management Improvement Program Core Financial System Requirements FFMSR-1, * as revised April 1994

Treasury Financial Manual, June 12, 1990

*Federal Financial Management Systems Requirements

Appendix C. Laws and Regulations Reviewed

GAO "Policy and Procedures Manual for Guidance of Federal Agencies," Title 2, "Accounting," May 18, 1988

OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993

OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993

OMB Circular No. 123, "Internal Control Systems," August 4, 1986

OMB Statement of Federal Financial Accounting Standards Number 1, "Accounting for Selected Assets and Liabilities," March 30, 1993

OMB Statement of Federal Financial Accounting Standards Number 2, "Accounting for Direct Loans and Loan Guarantees," August 23, 1993

OMB Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," October 27, 1993

OMB Statement of Federal Financial Accounting Concepts Number 1, "Objectives of Federal Financial Reporting," September 2, 1993

"DoD Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity," October 20, 1994

Appendix D. Summary of Work Performed by Others

Component	Business Area	FY 1994 Reported Assets	FY 1994 Reported Expenses	Scope of Audit Work Performed	Organizations Performing Audit Work	Audit Report Number
Army	Supply Management	\$14,975,924,957	\$12,584,846,437	Limited ¹	Army Audit Agency	NR95-430
	Depot Maintenance-Other	1,091,090,500	2,056,475,503	Limited ¹	Army Audit Agency	NR95-430
	Depot Maintenance-Ordnance	706,105,248	594,046,384	None	Army Audit Agency	Unaudited
	Consolidating	16,773,120,705	13,180,880,466 ²	Limited ¹	Army Audit Agency	NR95-430
Navy	Supply Management	18,123,446,838	8,323,057,157	Limited ¹	Naval Audit Service	044-95
	Distribution Depot	(135,938,702)	164,498,811	None	Naval Audit Service	Unaudited
	Depot Maintenance-Shipyards	1,796,674,104	3,749,156,310	Limited ¹	Naval Audit Service	044-95
	Depot Maintenance-Aviation	919,627,855	1,961,426,381	Limited ¹	Naval Audit Service	044-95
	Depot Maintenance-Ordnance	404,082,819	669,695,988	Limited ¹	Naval Audit Service	044-95
	Depot Maintenance-Other Marine Corps	(16,703,056)	181,062,050	None	IG, DoD ³	Unaudited
	Transportation-Military Sealift Command	132,490,257	720,645,068	Limited ¹	IG, DoD ³	95-259
	Base Support (includes Laundry Service)	989,276,307	1,920,158,628	Limited ¹	Naval Audit Service	044-95
	Logistics Support Activity	(8,959,609)	331,579,194	None	Naval Audit Service	Unaudited
	Naval Research Laboratories	143,286,607	502,796,098	Limited ¹	Naval Audit Service	044-95
	Naval Underseas Warfare Centers	342,800,307	993,057,693	Limited ¹	Naval Audit Service	044-95
	Naval Air Warfare Centers	422,059,395	2,684,581,970	Limited ¹	Naval Audit Service	044-95
	Naval Surface Warfare Centers	491,573,179	2,541,571,452	Limited ¹	Naval Audit Service	044-95
	Naval Command, Control & Ocean Surveillance Center	210,173,257	961,495,606	Limited ¹	Naval Audit Service	044-95
	Naval Civil Engineering Laboratories	8,791,624	50,206,100	None	Naval Audit Service	Unaudited
	Information Services	102,147,160	367,097,718	None	Naval Audit Service	Unaudited
	Printing and Publications	120,647,011	412,966,674	Limited ¹	Naval Audit Service	044-95
	Consolidating	25,063,883,444 ²	26,534,773,752 ²	Limited ¹	Naval Audit Service	044-95
Air Force	Supply Management	34,216,473,284	9,945,975,954	Limited ¹	Air Force Audit Agency	94068041
	Base Support	8,640,810	7,129,207	None	Air Force Audit Agency/IG, DoD ³	Unaudited
	Transportation-Air Mobility Command	734,892,676	2,782,341,003	Limited ¹	Air Force Audit Agency	94068040
	Depot Maintenance	1,399,219,672	4,221,789,210	Limited ¹	Air Force Audit Agency	94068039
	Consolidating	36,182,650,442 ²	13,211,350,219 ²	None	Air Force Audit Agency	Unaudited

¹The audit was limited to a review of the Statement of Financial Position.

²Amounts do not agree with the Component's financial statement.

³Included in IG, DoD, consolidated TRANSCOM audit (Report No. 95-259).

⁴The audit was limited to a review of selected accounts.

⁵The audit was limited to a review of the Statement of Financial Position and the Statement of Operations.

Appendix D. Summary of Work Performed by Others

Component	Business Area	FY 1994 Reported Assets	FY 1994 Reported Expenses	Scope of Audit Work Performed	Organization Performing Audit Work	Audit Report Number
Defense Logistics Agency	Supply Management Distribution Depots Reutilization and Marketing Service Industrial Plant and Equipment Center Clothing Factory Consolidating	12,164,108,079 943,921,378 576,866,260 177,538,370 7,077,127 13,869,511,214	12,794,833,361 1,597,964,120 367,289,330 23,795,246 26,640,839 14,810,522,896	Limited ⁴ Limited ⁴ Limited ⁴ None None None	IG, DoD IG, DoD IG, DoD None None None	95-195 95-197 95-220 Unaudited Unaudited Unaudited
Defense Technical Information Center	Consolidating	49,419,798	78,549,340	None		Unaudited
Defense Information Systems Agency	Communications Information Services Activity Defense Information Service Organization	495,144,000 335,866,418	1,503,327,000 592,802,015	Limited ⁵ Limited ⁴	IG, DoD IG, DoD	95-219 95-209
Defense Finance and Accounting Service	DFAS Operations	384,551,513	1,692,482,390	None		Unaudited
Defense Commissary Agency	Commissary Operations Resale Stocks Consolidating	(1,164,193,000) 756,003,000 (408,190,000)	1,087,244,000 5,579,301,000 6,666,545,000	Limited ⁵ Limited ¹ None	IG, DoD IG, DoD	95-217 95-228 Unaudited
Joint Logistics Service Center	Consolidating	198,030,897	29,763,124	None		Unaudited
U.S. Transportation Command	Consolidating	3,180,445,653	5,678,275,073	Limited ¹	IG, DoD	95-259
Corporate Account	Consolidating	7,869,663	287,303	None		Unaudited
Departmental	Consolidating	6,547,882,814	729,928,705	None		Unaudited
Total		\$102,622,403,632 ²	\$83,249,629,874 ²			

¹The audit was limited to a review of the Statement of Financial Position.

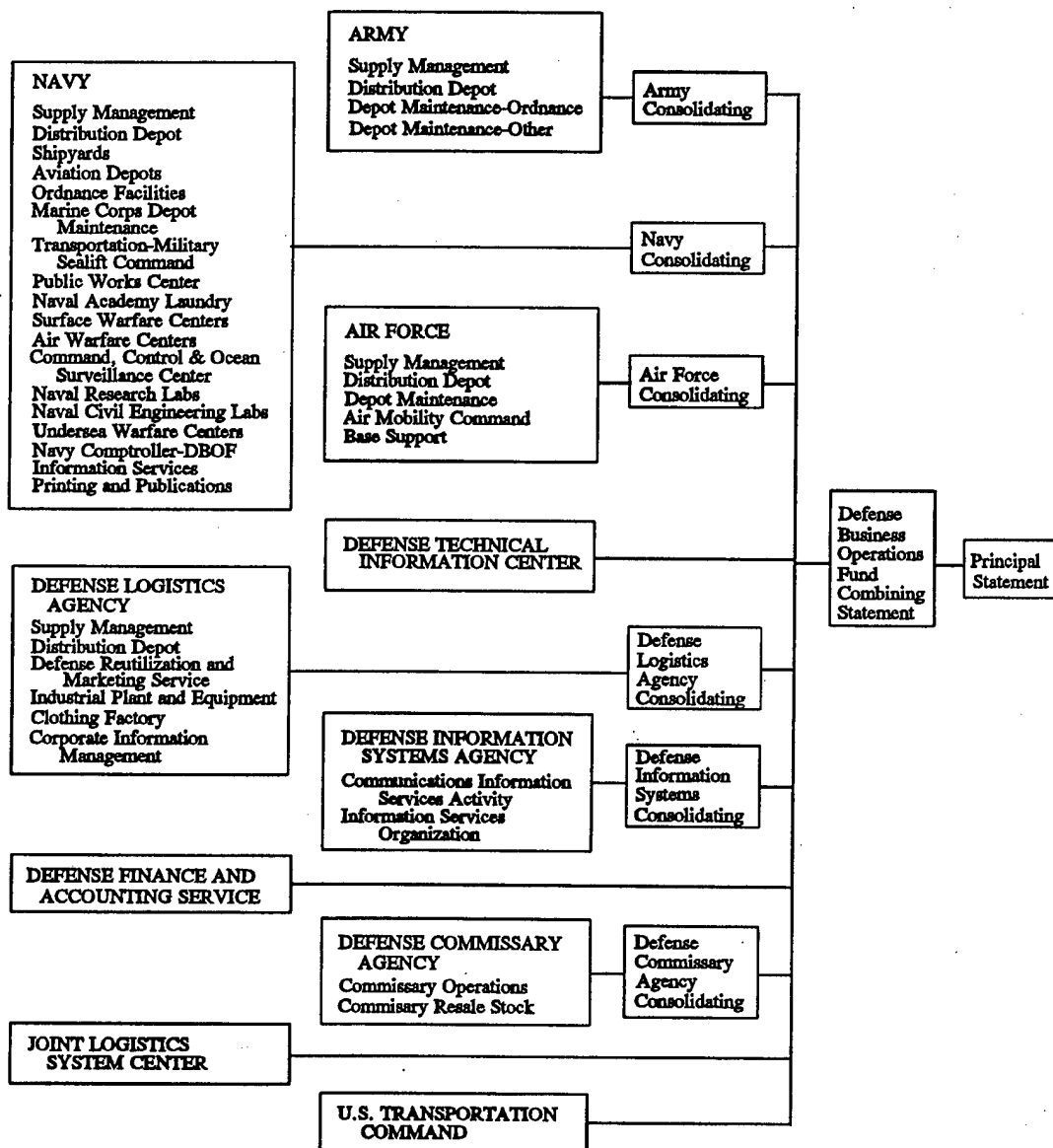
²Amounts do not agree with the Component's financial statement.

³Included in IG, DoD, consolidated TRANSCOM audit (Report No. 95-259).

⁴The audit was limited to a review of selected accounts.

⁵The audit was limited to a review of the Statement of Financial Position and the Statement of Operations.

Appendix E. Financial Statement Reporting Structure for the Defense Business Operations Fund



Appendix F. Management Representation Letter



COMPTROLLER

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAY - 4 1995



MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Management Representation Letter for the Defense
Business Operations Fund Financial Statements for
FY 1994 (Project 4FH-2010)

For the purpose of expressing an opinion on whether the FY 1994 Principal Financial Statements for the Defense Business Operations Fund (Project No. 4FH-2010), are presented fairly and in accordance with generally accepted accounting principles and Office of Management and Budget (OMB) Bulletin 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, I confirm, to the best of my knowledge and belief, the following representations:

- I am responsible for the fair presentation of the Defense Business Operations Fund financial statements in accordance with generally accepted accounting principles or OMB Bulletin 94-01.
- All financial records and related data have been made available to you.
- I have no plans or intentions, other than those previously disclosed to you, that may materially affect the carrying value or classification of assets and liabilities.
- I have no knowledge of irregularities involving management or employees who have significant roles in the internal control structure that are not a matter of public record.
- I have no knowledge of other employees being involved in irregularities that could materially affect the financial statements that are not a matter of public record.
- I have not received communications from regulatory agencies or auditors concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements that are not a matter of public record.
- Related third-party transactions and related amounts receivable or payable of interested participants, including assessments, loans, and guarantees, are not applicable.
- I have no knowledge of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements, or, as a basis for recording a loss contingency, that are not a matter of public record.

Appendix F. Management Representation Letter

- There are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies," March 1975.

- There are no unasserted claims or assessments that our legal representatives have advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board Statement No. 5. If there are any such claims, they will be reported in the legal representation letter for the Defense Business Operations Fund that will be furnished shortly to you by the General Counsel of the Department.

- I have no knowledge of material transactions that have not been properly recorded in the accounting records underlying the financial statements that are not a matter of public record.

- Provisions, for material amounts, have been made to reduce excess or obsolete inventories to their estimated net realizable value.

- To my knowledge, the Federal Government has satisfactory title to all reported assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral.

- Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

- I have no knowledge of noncompliance with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

- I have no knowledge of events that have occurred after the balance sheet date that would require adjustment to or disclosure in the financial statements that have not been previously identified on the statements.

- Attached are identified procedural and systemic deficiencies that may prevent an auditor from expressing an unqualified opinion on the financial statements.

Our staff contact for this matter is Mr. Oscar G. Covell. He may be reached at (703) 697-6149.


John J. Hamre

Attachment

Appendix F. Management Representation Letter

IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

Part 1. Departures from Published Accounting Policies and Procedures

Systemic and procedural deficiencies existed in the Department's accounting and financial management systems during FY 1994. The Department expects that a Disclaimer of Opinion will be issued on the FY 1994 financial statements of the Defense Business Operations Fund (DBOF). The following list summarizes the known deficiencies within the accounting and financial management systems used to account for and report on financial activity for the Defense Business Operations Fund.

A. General Ledger Control/Lack of Uniform Accounting Systems.

The accounting systems in use by the Department do not provide consistency in financial reporting or comparability of information on operations for the DBOF. The Chief Financial Officers (CFO) Act requires the CFO of each covered agency develop and maintain an integrated agency accounting and financial management system. Such systems are to provide for complete, reliable, consistent, and timely information prepared on a uniform basis and responsive to the financial information needs of agency management. The Department is using existing accounting systems to provide Service-unique information, although the DBOF reporting requirements are the same for each Military Service. Many of the DBOF activities are supported by unique computer programs used to summarize information for reporting to the DBOF. The summarized information must be collected from several Service-unique sources, which results in a further lack of comparability for data received for the DBOF.

In general, DBOF activities do not have an effective reporting system that systematically summarizes financial information and, in some cases, documented procedures do not exist to determine which general ledger accounts were used to develop the various account classifications on the financial statements. Consequently, for the FY 1994 financial statements, preparers had to crosswalk general ledger accounts to the DoD uniform chart of accounts, then crosswalk the DoD accounts to the account classifications on the financial statements. In addition, integrated general ledger systems were not always used to produce the FY 1994 financial statements. Instead, reports from departmental budget and reporting systems were relied on to prepare financial reports. Similarly, some DBOF business areas did not have a fully integrated double-entry accounting system. Information was gathered from automated and manual systems to create a consolidated general ledger. The procedures used to create this general ledger were not fully documented, and there are no procedures in place to assure that all transactions were recorded. Automated accounting systems were not always in place to collect and report expenses as required, and the accounting systems did not generate sufficient and suitable accounting data

Attachment

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to permit the review and certification of fiscal year financial statements. These conditions exist because the U.S. Government Standard General Ledger (USGSGL) accounts have not been incorporated into the DFAS accounting systems

B. Integrated General Ledger. The Department's accounting systems do not use an integrated general ledger double entry type system, from which financial statements can be produced. Consequently, not all of the reported financial position flows from, and is supported by, either a general ledger system or a subsidiary accounting system. The DoD Components currently use a combination of logistics systems, budgetary information, and data from other ancillary systems to compute property valuations for financial statements. The absence of a fully integrated general ledger system for all DoD assets limits the Department's capability to ascertain whether all assets are included in financial statement amounts because there is no standard financial control over the amounts reported.

C. Standard General Ledger. The U.S. Government Standard General Ledger (USGSGL) has not been fully implemented for the DBOF business areas. During FY 1993, at least seven different general ledger structures were in use by DBOF activities. The USGSGL is intended to standardize Federal accounting and meet the basic Federal financial statement and budget execution reporting requirements. The DoD Components are using Component-unique charts of accounts and are crosswalking the financial data from the activities' general ledger accounts to the USGSGL for preparation of management reports and financial statements. The lack of a uniform general ledger within the DBOF unnecessarily increases the potential for accounting errors and increases the level of effort required to prepare and audit financial statements or management reports for the use of other government offices, such as the Treasury Department and the OMB. Since the crosswalks in use do not always have a one-for-one relationship to accounts in the USGSGL, transactions are not always recorded and accounted for properly to permit the preparation of reliable financial statements and maintain financial accountability over assets.

In addition, the absence of a standard general ledger accounting system makes it difficult to ascertain whether like items are reported in general ledger balances because there are no standard financial controls for the amounts reported. The Department began implementing standard migration accounting systems in FY 1992. These systems will be used in the future as the transition is made from many accounting systems to standard, transaction driven, integrated, general ledger accounting systems.

D. Integrated Systems. The issue of integrating accounting systems with personnel, logistics, acquisition, and other systems has been a long standing problem for the Department. The Department has initiated some actions to address this area.

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IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

For example, the Defense Finance and Accounting Service (DFAS) is continuing the process of selecting migration systems for broader application and standardization within the Department. The DFAS also is evaluating the interface of systems and the sharing of data bases both within accounting and finance functional area and with other functional areas such as personnel, logistics, and acquisition.

E. Inadequate Systems. In the preparation of the Defense Business Operations Fund financial statements for FY 1994, some functional systems that feed significant data to the accounting systems were not reviewed adequately for conformance with applicable accounting requirements. Internal controls were inadequate in these feeder systems to ensure that items were inventoried or accounted for properly.

F. Inadequate Coding Structure. The Department's coding structure within the accounting and financial management systems employed by DBOF activities have not been developed to capture and report adequately the data necessary for preparing DBOF financial statements. For example, a coding structure does not exist to capture and report on (1) interfund transactions within the DoD Components and (2) primary and secondary areas within the DBOF.

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IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

Part 2. Internal Controls

- A. Fund Balances With Treasury Not Reconciled. Unreconciled differences in disbursement and collection transactions may result in accounting discrepancies between control accounts and installation level subsidiary accounting records for Air Force DBOF activities.
- B. Inadequate Internal Controls. The internal controls governing the processes for preparing financial statements still are not adequate for significant portions of the adjustment and financial statement preparation processes.
- C. Advances Not Recorded Properly. Accounting offices do not always manage outstanding travel advances adequately, and do not always accurately record advances in the accounting records.
- D. Inaccurate Reporting of Plant, Property and Equipment. Although the auditors may note some progress, overall procedures and controls are not adequate to ensure that the value of plant, property and equipment are reported accurately in the Statement of Financial Position.
- E. Property Records Not Reconciled. Additional improvements by the DoD Components are needed to account for equipment, and reconcile equipment values with subsidiary records.
- F. Inadequate Accounting for Receivables and Payables. Accounts receivable and payable are not always recorded in the proper accounting period or reconciled to general ledger account balances.
- J. Misclassification of Assets. Some installation level personnel may misclassify equipment, inventories held for sale and inventories not held for sale.
- H. Inadequate Analytical Review of Account Balances. Some DoD personnel do not always adequately review the reasonableness of amounts reported in the accounting records and financial statements.
- I. Lack of Supporting Documentation. Some personnel do not always obtain or maintain adequate documentation to support the validity and accuracy of fund control transactions.
- J. Misstated Other, Non-Federal and Federal Accounts. The Department of the Navy DBOF Consolidated Financial Statements may materially misstate the balances of the Other, Non-Federal and Other Federal accounts. Those misstatements may occur due to improper posting of undistributed collections and disbursements to these accounts.

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K. In-Transit Accounts Not Reconciled. DBOF in-transit inventory accounts for procurements, transfers between storage locations, and customer sales returns may remain in-transit from 181 to 360 days and, in some cases, more than 360 days.

L. Undocumented Adjustments to Financial Records. DBOF wholesale and retail activities may adjust financial records to match logistical records without researching the differences or trying to determine the causes for the variances.

M. Physical Inventory Counts Unreliable. Auditors may conclude that the physical inventory counting procedures and statistical sampling plans used by DBOF activities to assess the accuracy of inventories Not Held for Sale are incomplete, unsound, or statistically invalid.

N. Excess Material Valued Incorrectly. Excess material may be valued at latest acquisition cost vice the prescribed percent of latest acquisition cost.

O. Retention of Excess Material. Excess material may accumulate because personnel do not want to purge inactive items from their inventories due to the perceived negative effect such action would have on local operating results and financial statement presentation.

P. Failure to Follow Accrual Accounting Practices. Controls are not always in place to ensure that program or operating expenses are recorded when liabilities were incurred and revenues are recorded when earned.

Q. Transactions For and By Others Not Recorded in a Timely Manner. Timing differences in recording transactions result in variances between amounts maintained at and reported by the DFAS Centers vice those reported by individual business areas. The transactions for and by others are not recorded at the business area level until the transactions have been reviewed and accepted. This lag in reporting causes discrepancies between financial data at the DFAS Centers and operating data at the business areas and results in "unmatched" buyer and seller transactions, unliquidated obligations, and undistributed balances. The variances overstate accounts receivable and payable at the business areas. Also, subsidiary records are not available in sufficient detail to support undistributed disbursements and undistributed collections.

R. Improper Elimination or Reporting of Intrafund Transactions. Intrafund transactions among business areas of the DBOF are not properly identified or eliminated from the DBOF Combining or Consolidated financial statements for FY 1994. This is a result of the lack of specific DBOF policies, procedures, and controls for the treatment of these transactions. In addition, the present accounting systems used to record disbursements and collections are not designed to

Appendix F. Management Representation Letter

IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

identify and retain the intrafund data when both the buyer and seller are DBOF activities. Due to the lack of guidance and inadequate accounting systems, the amount of intrafund transactions that should have been eliminated or disclosed in the DBOF financial statements could not be determined.

S. Cash Accounts Not Reconciled. In many instances, neither the DBOF reporting entity program manager nor the accounting activity have performed adequate reconciliations between the general ledger Fund Balance with Treasury account and actual balances reported by the U.S. Treasury. Such conditions exist because procedures for performing reconciliations of the cash account are not in place. Further, general ledger totals frequently do not agree with totals and amounts for collections and disbursements on subsidiary records. Reference numbers on some transactions have been inappropriately changed, which results in some transactions not being uniquely referenced to individual source records.

T. Inconsistencies with Other External Reports. Review of the FY 1994 consolidating principal statements reveals the following inconsistencies as of September 30, 1994:

1. Funds Collected and Funds Disbursed (lines 1.a.(1)(a) and 1.a.(1)(b) of the consolidating statement) have been reported incorrectly by various DoD Components on the Statement of Financial Position. Amounts reported in the principal statements do not equal the reported Reimbursements Collected and Disbursements (Net of Refunds) on lines 14B and 14A, respectively, of the Reports on Budget Execution (DD Form 1176). Those components showing inconsistent amounts are the Army, Navy, Defense Logistics Agency (DLA), and the Defense Information Systems Agency (DISA).

2. Resources on the Statement of Budget and Actual Expenses have been reported incorrectly by nine of the DoD Components. The amounts reported as "Total Resources" should equal line 6 of the DD Form 1176. Those components include the consolidated DBOF total, Army, Navy, Air Force, DLA, DISA, Defense Commissary Agency (DeCA), Joint Logistics Systems Center (JLSC) and the U.S. Transportation Command (TRANSCOM).

3. Total obligations on the Statement of Budget and Actual Expenses have been reported incorrectly by three of the DoD Components and for the DBOF in total. Those Components are the Air Force, DLA and DeCA.

4. Direct and Reimbursable obligations reported in the third and fourth columns of the Statement of Budget and Actual Expenses should be equal to lines 7A and 7B of the Report on Budget Execution (DD Form 1176) but do not.

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IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

5. Expenses shown on the Statement of Budget and Actual Expenses and those reported in the Statement of Operations and Changes in Financial Position should agree, but do not. The amounts shown on the Statement of Budget and Actual Expenses should agree with the amounts reported on line 15 of the Combining Statement for the Statement of Operations and Changes in Financial Position. Expenses have been reported incorrectly by two of the DoD Components and for the DBOF in total. Those Components are Navy and DeCA.

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IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

Part 3. Compliance

Accounting systems and operational procedures used for the preparation of financial statements for the Business Operations Fund were not always in compliance with requirements of the "DoD Guidance on Form and Content of Financial Statements for FY 1994 /1995 Financial Activity," dated October 1994, and OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," dated November 16, 1993.

1. Procedures Not Followed in Financial Statement Preparation. Entries to eliminate or disclose intrafund transactions within the DBOF were not properly recorded, financial statements were overstated and understated because depreciation was not always computed correctly, accounts receivable were not always confirmed, revenue was not always recognized, and liabilities were not always properly recorded.

2. Record Retention Requirements Not Followed. Some accounting offices do not retain all financial records necessary to document the posting of individual payment transactions to budgetary accounts (obligations and expenditures) and general ledger accounts. Failure to retain these records of payments represent material noncompliance with laws and regulations governing the retention of financial records.

3. Accrual Accounting Procedures Not Followed. General ledger and subsidiary accounts are not always established as required and, in some cases, miscellaneous revenues either have not been recorded when earned or not recorded at all. Reporting entities do not promptly process all receipt information. Consequently, expenses frequently are not recorded prior to disbursements.

4. Widespread Lack of Compliance with Other Policies and Procedures or Generally Accepted Accounting Principles. Some reporting entities do not comply with requirements to reconcile fund balances with the Treasury, do not always match financial records to accounting records for capital assets, do not always develop depreciation schedules for capital assets, do not always record the transfer of assets, or do not always make required financial disclosures. In addition, activities do not always comply with the provisions of the Prompt Payment Act, and do not always comply fully with the Federal Managers' Financial Integrity Act. Some entities do not have accounting systems that always properly record and control budgetary and financial data.

5. Unreliable General Ledgers. Not all the accounting activities or reporting entities have controls in place to ensure that all valid transactions are properly recorded, processed, and summarized in order to always provide accurate financial information to fund managers. Rather than using the

IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

general ledger to account for major assets, most reporting entities frequently rely on information derived from operational and logistics systems. In addition, there is a lack of assurance that source data always is accurate because some discrepancies in the operational and logistics systems are not investigated in a timely manner.

6. Unsupported Adjustments Made to General Ledger Accounts. Adjusting entries are sometimes made without required supporting documents. As a result, accounting adjustments or related account balances reported in the financial statements are not substantiated. Some program managers make incorrect or unsupported entries to year-end inventory accounts on the financial statements because effective procedures for making adjusting entries have not yet been established.

7. Inadequate or Nonexistent Audit Trails. Some reporting entities have not established adequate audit trails to enable managers or auditors to verify disbursements. In some cases, payments posted to records cannot be traced to the records of the DoD Components that recorded the payments due to inadequate system capabilities.

Appendix G. Organizations Visited or Contacted

Office of the Secretary of Defense

Office of the Under Secretary of Defense (Comptroller), Washington, DC
Office of the Deputy Comptroller (Program and Budget), Director of Revolving
Funds, Washington, DC
Office of the Deputy Comptroller (Financial Systems), Director of Accounting
Policy, Washington, DC
Deputy Under Secretary of Defense (Logistics), Washington, DC

Department of the Army

Army Audit Agency, Arlington, VA
Letterkenny Army Depot, PA

Department of the Navy

Naval Audit Service, Arlington, VA
Naval Supply Systems Command, Arlington, VA
Naval Audit Service, Southeast Region, Virginia Beach, VA

Department of the Air Force

Air Force Audit Agency, Wright-Patterson Air Force Base, Dayton, OH

Other Defense Organizations

Defense Finance and Accounting Service, Arlington, VA
Defense Finance and Accounting Service Columbus Center, Columbus, OH
Defense Finance and Accounting Service Denver Center, Denver, CO
Defense Finance and Accounting Service Indianapolis Center, Indianapolis, IN
Defense Accounting Office, Arlington, VA
Defense Logistics Agency, Arlington, VA

Appendix H. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Acquisition & Technology)
Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Office of the Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Assistant to the Secretary of Defense (Public Affairs)
Deputy Under Secretary of Defense (Logistics)

Department of the Army

Secretary of the Army
Assistant Secretary of the Army (Financial Management)
Assistant Secretary of the Army (Installations and Logistics)
Assistant Secretary of the Army (Research, Development and Acquisition)
Auditor General, Department of the Army

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Acquisition)
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Appendix H. Report Distribution

Other Defense Organizations

Director, Defense Finance and Accounting Service
 Director, Defense Finance and Accounting Service Cleveland Center
 Director, Defense Finance and Accounting Service Columbus Center
 Director, Defense Finance and Accounting Service Denver Center
 Director, Defense Finance and Accounting Service Indianapolis Center
Director, Defense Commissary Agency
Director, Defense Contract Audit Agency
Director, Defense Information Systems Agency
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, Defense Intelligence Agency
Inspector General, National Security Agency

Non-Defense Federal Organizations

Office of Management and Budget
National Security and International Affairs Division, Technical Information Center,
 U.S. General Accounting Office

Chairman and ranking minority member of each of the following congressional
committees and subcommittees:

Senate Committee on Appropriations
 Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
 House Subcommittee on National Security, Committee on Appropriations
House Committee on National Security
House Committee on Government Reform and Oversight
 House Subcommittee on National Security, International Affairs and Criminal
 Justice, Committee on Government Reform and Oversight

Part IV - Management Comments

Under Secretary of Defense (Comptroller) Comments



OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100



JUN 21 1995

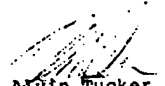
MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Audit Report on the Defense Business Operations Fund
Consolidated Statement of Financial Position for
FY 1994 (Project No. 4FH-2010)

This memorandum responds to your May 25, 1994, memorandum requesting comments concerning the subject draft audit report on the Department of Defense, Defense Business Operations Fund (DBOF) financial statements for FY 1994. Specific comments on the draft report findings are attached.

This office generally concurs with the audit findings. Unfortunately, the results of the audit of the Defense Business Operation Fund's consolidated financial statements for fiscal year 1994 are similar to the results of the prior year audit. Inadequate internal controls and undocumented audit trails have contributed to unreliable financial data and exacerbated significant procedural and systemic deficiencies. This is due largely, but not entirely, to long standing systems problems. The continuing system problems remain a serious challenge to the Department--and realistically will require a number of years to correct. However, these financial audits also have shown that actions, short of substantive system changes, can be, and are being, taken to improve operations. Progress has been made in addressing the resolution of non-systematic problems. Additionally, many actions either are planned or ongoing to redress current system deficiencies.

My point of contact on this matter is Mr. Oscar G. Covell. He may be reached at (703) 697-6149.


Alvin Tucker
Deputy Chief Financial Officer

Attachment

Under Secretary of Defense (Comptroller) Comments

AUDIT REPORT ON THE DEFENSE BUSINESS OPERATIONS FUND CONSOLIDATED STATEMENT OF FINANCIAL POSITION FOR FY 1994 (PROJECT NO. 4PB-2010)

UNDER SECRETARY OF DEFENSE (COMPTROLLER) COMMENTS

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FINDINGS - PART 1 INTERNAL CONTROLS

- **DODIG FINDING 1: Inventory In-Transit.** In July 1994, DFAS Denver Center personnel acknowledged to the Air Force Audit Agency that material weaknesses existed in the Inventory In-Transit account. In August 1994, the Air Force Audit Agency informed the IG, DoD, of significant problems involving the Inventory In-Transit account within the Air Force Business Operations Fund. The Air Force business activities had a negative balance of approximately \$7.5 billion in the Inventory In-Transit account, which is 7.3 percent of the total DBOF assets and 11 percent of the total DBOF Inventory, Net, account. The existence of a negative balance in an inventory account is a physical impossibility, and the large misstatement indicates that the accounting systems that produce those figures cannot be relied on. The fact that accounting systems, a significant element of the internal control structure, cannot be relied on is a basis for our disclaimer.

DOD RESPONSE: Air Force inventories are reported in the Supply Management business area. The Air Force Audit Agency (AFAA) draft report 94068041 on the Supply Management business area indicated that the negative inventory in-transit was \$3.8 billion, not the \$7.5 billion included in this report. The draft DoDIG report should be revised to reflect the \$3.8 billion value for inventory in-transit. The Under Secretary of Defense (Comptroller) will initiate correspondence to the accounting and logistics communities requesting that the source of the problem(s) be identified and deficiencies corrected.

- **DODIG FINDING 2: Accounts Receivable.** Unsupported and unverified transactions recorded in the Defense Logistics Agency Distribution Depot and the Air Force Depot Maintenance business areas caused Accounts Receivable to be misstated by \$511.8 million (6.2 percent of the Consolidated account). Incorrect recording of Accounts Receivable also caused an overstatement of \$194.8 million (2.4 percent of the Consolidated account). Weak internal controls caused reimbursements to be collected but not posted or recorded; also, funding documents were not received, which prevented the activities from billing customers. Overstatements in

Under Secretary of Defense (Comptroller) Comments

Accounts Receivable may lead management to make decisions based on a false assumption that the activities have more resources than they actually have. Also, errors in recording Accounts Receivable may cause activities to be delayed or unable to bill customers. No material internal control weaknesses for Accounts Receivable were found at the Army Business Operations Fund activities.

DOD RESPONSE: The Department concurs that internal controls appear to need strengthening in the recordation of funding documents. The statement "Overstatements in Accounts Receivable may lead management to make decisions based on a false assumption that the activities have more resources than they actually have" is incorrect in that resources available to the activity are derived from reimbursable funding documents not accounts receivable. In addition, the Department will review the requirements for documents supporting the recordation of accounts receivable.

Lastly, the draft report, on Table 2, item 3, states that an increase to balance the general ledger with Treasury records was unsupported and unverifiable. Inspector General, DoD, Report No 95-197 indicates that this adjustment was made for undistributed collections, but states that this practice is not in accordance with generally accepted accounting principles. These statements do not recognize that the practice is in accordance with DoD accounting policy for adjustments of undistributed amounts.

- **DODIG FINDING 3:** Property, Plant, and Equipment. The Property, Plant, and Equipment account was overstated by a net of \$63.2 million (0.6 percent of the Consolidated account) on the Navy DBOF Financial Statements. The account was overstated because assets could not be located, costs were unsupported, and assets were incorrectly recorded. The Naval Audit Service recommended and the Department made adjustments to the Navy DBOF Statement of Financial Position for September 30, 1994, to correct the overstatement.

DOD RESPONSE: The Department agrees that the proposed adjustments were made.

- **DODIG FINDING 4:** Accounts Payable. The IG, DoD, the Naval Audit Service, and the Air Force Audit Agency found reportable conditions in Accounts Payable that affected the reliability of the Accounts Payable balances. Those conditions included accounting errors, negative balances, disbursements not posted to the individual Accounts Payable balances, Accounts Payable disbursements that were not recorded, and failure to maintain supporting documentation. Error in recording Accounts Payable may result in multiple payments for the same services.

DOD RESPONSE: The Department does not agree with item 7 in Table 3 on page 19. This item states that an increase to balance the general ledger to Treasury records was unsupported and unverifiable. DoDIG Report No. 95-197 indicates that this adjustment was made for undistributed disbursements but states that this practice was not in accordance with generally accepted accounting principles. The report indicated that this finding also had been identified in FY 1993. The report did not recognize that the practice is in accordance with DoD accounting policy for adjustments of undistributed disbursements and that the OUSD(C) had nonconcurred on the FY 1993 audit report.

- **DODIG FINDING 5: Other Intragovernmental Liabilities.** The Army's Other Intragovernmental Liabilities account contained invalid transactions of \$351 million (5.4 percent of the Consolidated account). At one inventory control point, an overstatement occurred because the activity did not recoup credits given to retail customers when the customers failed to return assets. In addition, the inventory control point gave erroneous credits for returned items with credit value that exceeded unit prices. However, the activities made adjustments to the financial statements before submitting year-end account balances to the DFAS Indianapolis Center.

The Navy's Other Liabilities account was overstated by \$359.1 million (5.5 percent of the Consolidated account). The account balance was misstated because of system-wide processing problems. Because of the misstatement, there is no assurance that the Other Liabilities account is accurate and reliable. Also, \$359.1 million represents funds that could be put to better use. The Naval Audit Service recommended that to correct the overstatement, the Director, DFAS, should adjust the Other Liabilities account by \$359.1 million on the September 30, 1994, Navy DEOP Financial Statements.

DOD RESPONSE: An adjustment was made to the Navy's consolidated financial statements to correct the error.

- **DODIG FINDING 6: Intrafund Eliminations.** The Navy did not include the required Intrafund Eliminations note to the financial statements. The Navy should have included at least \$3.2 billion relating to collections and disbursements in the Intrafund Eliminations note. This problem occurred because the Navy did not have procedures needed to collect data for the note. The Naval Audit Service recommended that DFAS aggressively pursue and develop intrafund elimination reporting procedures for presentation of the FY 1995 financial statements.

DOD RESPONSE: The Department agrees that the required footnote was not included in the Navy statements.

Under Secretary of Defense (Comptroller) Comments

- **DODIG FINDING 7: Presentation of Financial Statements.** In reviewing the individual DBOF activity financial statements, we found inconsistencies in the amounts in which the figures were expressed. The final versions of the financial statements for four DBOF activities state that the figures are expressed in thousands of dollars, when they are actually expressed in dollars. The financial statements in error are those of the Defense Logistics Agency, the Defense Technical Information Center, the Defense Information Systems Agency, and the Defense Finance and Accounting Service.

DOD RESPONSE: While the report is correct in identifying that four DoD Component statements incorrectly identified the statements as being in thousands of dollars, the report did not acknowledge that the Component amounts were identified correctly in the DBOF Consolidated Financial Statements.

Under Secretary of Defense (Comptroller) Comments

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FINDINGS - PART 2 COMPLIANCE

- **DODIG FINDING 1: Accounting Systems.** OMB Circular No. A-127, "Financial Management Systems," requires that accounting systems interface with logistical systems and meet other requirements such as system documentation, audit trails, and general ledger control. The FY 1994 DFAS Annual Statement of Assurance reported that the majority of the 261 financial management systems do not meet the requirements of OMB Circular No. A-127. Many of the systems perform similar functions, which results in inefficiencies and disparate business practices.

DOD RESPONSE: The Department agrees with the facts presented in this finding.

- **DODIG FINDING 2: Standard General Ledger.** The "DoD Accounting Manual" requires activities to use the standard general ledger chart of accounts. The USD(C) acknowledges that the standard general ledger has not been implemented in the DBOF business areas. One of the systems used by Army's supply management, the Commodity Command Standard System, was not using standard general ledger accounts. As a result of a financial statement audit, the U.S. Army Materiel Command submitted a system change request that would implement the standard general ledger. The change should be implemented on October 1, 1995. Two systems used by retail activities, the Standard Army Intermediate Level Supply System and the Standard Army Financial Inventory Accounting and Reporting System, also did not use the standard general ledger. The systems have a conversion program that crosswalks obsolete general ledger accounts to the standard general accounts. These systems are scheduled to be replaced and will not be revised.

DOD RESPONSE: The Department agrees with the facts presented in this finding.

- **DODIG FINDING 3: Property, Plant, and Equipment.** The FMR requires activities to depreciate each building separately. However, existing accounting systems generally precluded determination of depreciation expense. For example, most Army depot maintenance activities do not have an accounting system that allows them to compute depreciation on separate buildings. The Army Materiel Command is addressing this issue.

DOD RESPONSE: The Department agrees with the facts presented in this finding.

Under Secretary of Defense (Comptroller) Comments

- **DODIG FINDING 4: Inventory Valuation.** The Army incorrectly valued inventory, resulting in misstatements of the Inventory account. In accordance with Statement of Federal Financial Accounting standards Number 3, "Accounting for Inventory and Related Property," July 30, 1993, DoD policy requires that inventory be revalued to its latest acquisition cost at year end. This policy also requires that excess, obsolete, and unserviceable material be valued at its net realizable value. Volume 11B of the FMR, December 1994, further clarifies how inventory should now be classified and valued. The Army Audit Agency found that the DFAS procedures were not comprehensive and recommended that DFAS clarify guidance on how to revalue Army supply management inventory. Army maintenance activities valued all inventory at standard price, regardless of condition, which resulted in overvalued excess and unserviceable inventory. The Army Audit Agency previously recommended that the Army Materiel Command develop procedures for valuing excess and unserviceable inventory held by Depot Maintenance activities.

The Navy DBOF activities did not report excess inventories correctly because disposal of excess items could negatively affect operating results. In addition, local policies did not allow material to be excessed unless credit was received from the supply system. As a result, Material/Supplies, Net, was overstated by \$84.8 million. The Naval Audit Service recommended that the Assistant Secretary of the Navy (Financial Management and Comptroller) identify Operating Materials/Supplies that are excess to requirements and take appropriate action. The Assistant Secretary should also revalue excess Operating Materials/Supplies for financial statement reporting.

DOD RESPONSE: The Department agrees with the facts presented in this finding.

- **DODIG FINDING 5: Cash Reconciliation.** Before FY 1995, the USD(C) was responsible for managing the Fund's cash. As of February 1, 1995, the USD(C) transferred responsibility for management of the Fund's cash to the DoD Components, the Military Departments, and the Defense agencies. The amounts reported as collected and disbursed on the Navy DBOF financial statements did not agree with individual activities' records, even after cash reconciliations were performed. The financial statement shows that \$22.2 billion was collected and \$24.4 billion was disbursed. These amounts represent the value of collections and disbursements that were successfully processed through the Navy's finance network. Preparers of the Navy's financial statements relied only on information processed through the Navy finance network, while activities used additional information and omitted some information from the finance network. Failure to match financial statements and activity

Under Secretary of Defense (Comptroller) Comments

records could result in cash management problems and potential Antideficiency Act violations.

DOD RESPONSE: The Department agrees with the facts presented in this finding.

- **DODIG FINDING 6: Accounting Estimates.** The "DoD Accounting Manual" requires that financial transactions be adequately supported with source records and pertinent documents, and prohibits estimates in the Statement of Accountability. The Navy used estimates for collection figures when ships and activities did not report figures in sufficient time to be incorporated in the statements. The Navy developed the estimating process to overcome timing and processing problems. This resulted in the overstatement of collections by \$803 million (1.1 percent of the Consolidated account) in FY 1994. Accounts Receivable was understated by the same amount. Additionally, disbursements were overstated by \$132 million (0.2 percent of the Consolidated account) in FY 1994, and Accounts Payable was understated by \$144 million. Invested Capital was also understated by \$362 million (0.4 percent of the Consolidated account) in FY 1994. The Naval Audit Service recommended adjustments to correct the errors in the financial statements. The Naval Audit Service also recommended that the Director, DFAS, stop estimating collections and disbursements for nonreporting activities.

On October 27, 1994, DFAS directed its subordinate activities to cease estimating and report actual balances only. As of February 28, 1995, two Defense Accounting Offices were still making monthly estimates. The net value of the improper increases in the Fund Balance with Treasury account totaled over \$800 million and represents an overstatement within that account on the Navy DBOF Statement of Financial Position. However, the Naval Audit Service concluded that eliminating those transactions would not result in a violation of the Antideficiency Act. The Naval Audit Service recommended that DFAS eliminate the estimated net collections from data reported to the Fund Balance with Treasury account. The Naval Audit Service also recommended that the Assistant Secretary of the Navy (Financial Management and Comptroller) direct appropriate business areas to bill additional amounts in advance to ensure that Antideficiency Act violations are avoided and cash level criteria are met.

DOD RESPONSE: The Department agrees with the facts presented in this finding.

Department of the Navy Comments



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D.C. 20380-1000

14 JUN 1995

MEMORANDUM FOR THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Subj: AUDIT REPORT ON THE DEFENSE BUSINESS OPERATIONS FUND
CONSOLIDATED STATEMENT OF FINANCIAL POSITION FOR FY 1994
(PROJECT NO. 4FH-2010)

Ref: (a) IG, DOD memo of 25 May 95

Encl: (1) Technical Comments to the Draft Subject Audit

I would like to make the following points on your draft audit report, reference (a). First, I strongly object to the unfair statements in your cover letter and in the draft report that your audit was impeded by the failure of the Department of Defense to provide timely consolidated financial statements in part due to repeated adjustments by Navy management. We have placed considerable emphasis on financial statements that fairly present the financial condition and operations of the Department of the Navy. For the Chief Financial Officers Act statements to achieve their intended purpose, it is incumbent that management fulfill its' responsibility to provide accurate information to the users of the statements. This responsibility is directly noted by your request for a Management Representation Letter.

Second, you clearly state that the Defense Finance and Accounting Service (DFAS) is responsible for the preparation of the financial statements and DFAS and the DOD Component are jointly responsible for the information in the statements. Both our review and the Naval Audit Service review of the statements disclosed material errors and omissions which would clearly mislead a user of the financial statements. The correction of these errors and omissions required a number of iterations yet yielded a set of financial statements potentially leading to a favorable opinion. To ignore these errors and omissions would be a major breach of management's responsibility.

Third, the efforts to correct these material errors and omissions were clearly documented for your review in our Management Representation Letter on the fiscal year 1994 statements. The problems with the Fiscal Year 1993 DBOF financial statements was also documented at length in our Management Representation Letter for that year.

Finally, I do not think it is reasonable to expect me or any other Department of Defense official to transmit material that I know contains significant errors and omissions. Since the presentation in the draft audit report does not present the

Department of the Navy Comments

Subj: AUDIT REPORT ON THE DEFENSE BUSINESS OPERATIONS FUND
CONSOLIDATED STATEMENT OF FINANCIAL POSITION FOR FY 1994
(PROJECT NO. 4FH-2010)

detailed information concerning the problems encountered during the preparation of these financial statements nor does it discuss the material errors and omissions in the various iterations to prepare these financial statements, I firmly believe that the unfair comments concerning the Department of the Navy be deleted from the draft audit report. Enclosure (1) provides technical corrections needed to your audit report.

Gladys J. Commons
GLADYS J. COMMONS
Principal Deputy
Assistant Secretary of the Navy
(Financial Management)

Technical Comments to the Draft Subject Audit

- 1. Property, Plant, and Equipment (top of page 18):** The last sentence should be revised because the Navy has not made adjustments to the Navy DBOF Statement of Financial Position for 30 September 1994 to correct the \$63.2 million of overstatements as stated in the draft audit report.
- 2. Other Intragovernmental Liabilities (second para, page 20):** The last sentence should be revised to indicate that the recommended adjustment of \$359.1 million has been made to the 30 September 1994 DON Consolidating DBOF Financial Statements.
- 3. Intrafund Eliminations (page 20):** This paragraph needs to be expanded to indicate that the Naval Audit Service audit report 053-H-94 "Fiscal Year 1993 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund," dated 29 June 1994, recommended that the Department of Defense develop policy to collect the data for elimination of intrafund transactions. This fact was noted in the Naval Audit Service audit report 044-95 "Fiscal Year 1994 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund," of 30 May 1995. Additionally, reference should be made to Appendix F of the DOD/IG audit report, the Under Secretary of Defense (Comptroller) memorandum of 4 May 1995, Management Representation Letter, which has identified procedural and systemic deficiencies regarding "Improper Elimination or Reporting of Intrafund Transactions" because of a lack of specific DBOF policies, procedures, and controls for treatment of these transactions.
- 4. Inventory Valuation (second para, page 24):** This paragraph should be revised to indicate that the auditors reported excess Operating Materials/Supplies value is \$57.3 million not \$84.8 million. This is supported by Table 4 of this draft audit report.
- 5. Accounting Estimates (pages 25 and 26):** The second to last sentence on page 26 should be revised to indicate that the recommended adjustments have been made to the 30 September 1994 DON Consolidating DBOF Financial Statements.
- 6. Appendix E. Financial Statement Reporting Structure for the Defense Business Operations Fund (page 42):** The list of the Navy reporting structure should be expanded to include "Logistics Support Activities" and to delete the "Navy Comptroller-DBOF."

Enclosure (1)

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

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